

1965

Federal Income Taxation of Professional Associations and Corporations

Stephen B. Scallen

Follow this and additional works at: <https://scholarship.law.umn.edu/mlr>



Part of the [Law Commons](#)

Recommended Citation

Scallen, Stephen B., "Federal Income Taxation of Professional Associations and Corporations" (1965). *Minnesota Law Review*. 2383.
<https://scholarship.law.umn.edu/mlr/2383>

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.

Federal Income Taxation of Professional Associations and Corporations

Many states have recently adopted legislation enabling certain professional organizations to adopt the corporate form. In view of this situation the Internal Revenue Service has amended the Federal Income Tax Regulations dealing with classification of these professional associations and corporations (the Kintner Regulations) in a manner which, if adopted by the courts, will deprive most of these groups of corporate status for federal tax purposes. This article offers comprehensive analysis of the classification problem by tracing the development of statutes, legislative history, case law, and the regulations. The article further analyzes the policy considerations behind the federal tax program as they bear on the classification issue and the newly amended regulations. The author concludes that neither historical developments nor policy reasons justify the discriminatory treatment the amended regulations accord these groups. In fact, these same considerations require the preferable course of allowing normal federal tax consequences to follow from the local law form of these professional organizations.

Stephen B. Scallen*

Over 30 states¹ have recently enacted laws granting certain professions the authority to carry on professional practice as corporations or as associations. These laws pertain to various professions, but are largely intended for the benefit of doctors and lawyers who heretofore have been precluded from using the corporate form.² Although these laws are intended to make avail-

*Associate Professor and Assistant Dean, University of Minnesota Law School.

1. At latest count, the number was 33. For a list of the state statutes and other authority enabling professional groups to practice as corporations, see 6 CCH 1965 STAND. FED. TAX REP. ¶ 5943.0973; 1 CCH PENSION PLAN GUIDE (2d ed.) ¶¶ 9000-105 (1965).

2. See, FIRSIG, CASES ON PROFESSIONAL RESPONSIBILITY 217-22 (1965). Now, however, professional ethics no longer bar the possibility of practicing a

able the corporate form to professional groups allowing them taxation as corporations, the Internal Revenue Service has stated that these groups are not to be taxable as corporations. The question of the correct classification of these organizations for federal income tax purposes is the subject of this article.

This problem of classification has its origins in the difference in taxation of partnerships on the one hand and corporations (and associations) on the other. At one time, the Commissioner generally sought to classify all borderline organizations as associations (taxable as corporations) — no doubt hoping thereby to collect a “double” tax on the earnings of those businesses. Now that use of the corporate form is generally thought to produce tax advantages,³ the Commissioner has reversed his field, seeking to classify borderline organizations as partnerships rather than as associations.

The Commissioner lost one early round of the battle when the

profession in the corporate form. In the Matter of the Florida Bar, 133 So. 2d 554 (Fla. 1961); Colo. R. Civ. P. 265; Opinion 303, 48 A.B.A.J. 159, 160 (1962); Snyder & Weckstein, *Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons*, 48 CORNELL L.Q. 613, 659-71 (1963).

3. First, the “double” tax will not be imposed if the corporation’s income can be offset by enough salary and other expense deductions. Second, many fringe benefits, with favorable tax consequences to employees, are available to employees of corporations, but not to partners of a partnership. (Partners are not considered to be “employees” under relevant sections of the Code; consequently, the fringe benefits named are not available for them.) Corporate employees may spread their income over a lifetime, thereby avoiding the undesirable tax consequences of bunching income into a few, high income producing years. This spreading may be accomplished through an employment contract. Besides the advantage of avoiding bunching, the employee also has the advantage of actually paying the tax later; although he also has to wait to use the money, he can rely on the existence of the contract as a factor in decisions about spending his current income, as against saving some of it; thereby he has some present enjoyment of the money he will later receive. Deferral of tax and avoiding of bunching can also be accomplished through pension and profit sharing plans. The corporation is entitled to a deduction for the contribution to the trust under the plan. INT. REV. CODE OF 1954, § 404(a). The employee, however, has no income for tax purposes at the time of the contribution, even though his rights may be fully “vested.” INT. REV. CODE OF 1954, § 402(a)(1). The trust pays no tax on its earnings and realized gains. INT. REV. CODE OF 1954, § 501(a). The employee is taxed only when he receives distributions from the trust and this can be at capital gain rates if he takes all his funds within one taxable year. INT. REV. CODE OF 1954, § 402(a)(1)-(2). The taxpayer has the advantage of an investment in a retirement plan without having to pay a tax on his enjoyment of the realization that his retirement is being funded until he actually receives funds upon retirement. The Code provisions regarding corporate pension and profit sharing plans do allow considerable discrimination in favor of the permanent, highly paid employees, in spite of recitals to the contrary. Thus

Ninth Circuit agreed to classification of a medical group as an association in *United States v. Kintner*.⁴ Thereafter changes in the relevant regulations were proposed and adopted.⁵ Because these changes, called the "Kintner Regulations," put added reliance upon certain criteria applied technically under local law, it became impossible for anything treated as a partnership under local law to be treated as an association under these regulations.

The response of professional groups to this technical, local law approach was to arrange a change in the local law. Professional groups sought, and obtained, special laws, fashioned with the Kintner Regulations carefully in mind, enabling them to do business as corporations or associations. The response of the Internal Revenue Service was to propose, and eventually adopt, amendments to the Kintner Regulations which would, if followed, deny classification of these professional groups as associations or corporations for federal tax purposes, even though organized under one of these professional associations or professional corporation laws. Such, briefly, is the history and the context of the problem.⁶

small corporation executives need not share "too much" of this tax advantage with employees.

There are other fringe benefit tax advantages to the use of the corporate form. The corporation may purchase group term life insurance for employees up to \$50,000 without the employees suffering a tax on the value of the premium paid for them. INT. REV. CODE OF 1954, § 79; Treas. Reg. § 1.61-2(d)(2) (1957), as amended, T.D. 6696, 1963-2 CUM. BULL. 23. Corporate employees, but not partners, also enjoy the sick pay exclusion and the \$5,000 exclusion for death benefit paid to a widow of an employee. INT. REV. CODE OF 1954, §§ 101(b)(2)(1), 105(d).

4. 216 F.2d 418 (1954); see text accompanying notes 162-74 *infra*.

5. See text accompanying notes 347-56 *infra*.

6. A bibliographical list of works on the subject of this article should include the following: 7 MERTENS, FEDERAL MEANS TAXATION ch. 38A (1956, Supp. 1964); Quimby, Professional Corporations and Association, June, 1963; Anderson, *Tax Aspects of Professional Corporations*, 15 U. So. CAL. 1963 TAX INST. 309; Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961); Brabson, *What Constitutes an Association Taxable as a Corporation*, 1949 N.Y.U. 7TH INST. ON FED. TAX. 1282; Buchmann & Bearden, *The Professional Service Corporation—A New Business Entity*, 16 U. MIAMI L. REV. 1 (1961); Bye & Young, *Law Firm Incorporation in Colorado*, 34 ROCKY MT. L. REV. 427 (1962); Deering, *Incorporation by Attorneys*, 42 ORE. L. REV. 93 (1963); Driscoll, *The Association Problem in Joint Ventures and Limited Partnerships*, 17 N.Y.U. INST. ON FED. TAX. 1067 (1959); Driscoll, *The Limited Partnership and the Association Question*, U. So. CAL. 1960 TAX INST. 539; Dunkel, *Professional Corporations*, 22 OHIO ST. L.J. 703 (1961); Eaton & Maycock, *Professional Corporations, Tax Benefits are not Lost in Today's New Hostile Climate*, 20 J. TAXATION 150 (1964); Eaton & Maycock, *Final Professional Corporation Regs are Improvement—But Not Much*, 22 J. TAXATION 208

Three approaches were used to change local law so that corporate status for these professional groups might be obtained. It is not within the scope of this article to describe each category in great detail, giving differences and similarities from state to state. However, the specific approaches used in three jurisdictions will

(1965); Eaton & Maycock, *Proposed Kintner Regs Arouse Many Protests as Being Inequitable and Discriminatory*, 20 J. TAXATION 222 (1964); Eber, *The Pros and Cons of the New Professional Service Corporations*, 15 J. TAXATION 308 (1961); Edwards, *Taxation—Unincorporated Associations and the Medical Profession*, 30 MISS. L.J. 293 (1959); Frost, *Some Comments as to Professional Corporation Statutes*, 4 ARIZONA L. REV. 169 (1963); Fuller, *Taxation of Louisiana Professional Partnerships as Associations*, 35 TUL. L. REV. 723 (1961); Grayck, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-Employed Individual's Tax Requirement Act of 1962 and the Professional Association*, 63 COLUM. L. REV. 415 (1963); Grayck, *Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments*, 17 TAX L. REV. 469 (1962); Hart, *Legislation by the I.R.S. and the Proposed Amendments to the Kintner Regulations*, 20 BUS. LAW. 235 (1964); Hewitt, *Associations Taxable as Corporations*, 47 A.B.A.J. 215 (1961); Hughes, *Associations After Stierwalt*, 1963 TULANE 12TH TAX INSTITUTE 341; Johnson, *Effect of the New Association Regulations on Oil and Gas Ventures*, SOUTHWESTERN LEGAL FOUNDATION 1962 INSTITUTE ON OIL & GAS TAXATION 503; Joyner, Pemberton & Taylor, *The Tax Dilemma of the Self-Employed Professional*, 28 MO. L. REV. 161 (1963); Kahn, *The Wisconsin Service Corporation Law of 1961*, 1962 WIS. L. REV. 65; Lyon, *Action in Indiana on Kintner-Type Organizations*, 39 TAXES 266 (1961); Lyons, *Comments on the New Regulations on Association*, 16 TAX L. REV. 441 (1961); Mackay, *Professional Associations Instead of Partnerships*, 1961 TULANE 10TH TAX INSTITUTE 409; Maier, *Professional Corporations and Kintner Association Advancing; Box Score to Date*, 17 J. TAXATION 2 (1962); Maier & Carter, *Is the Commissioner's Authority Exceeded in the Proposed Regulations for Professional Firms?*, 48 MARQ. L. REV. 361 (1965); Maier & Wild, *Taxation of Professional Firms as Corporations*, 44 MARQ. L. REV. 127 (1960); Ohl, *Corporate Practice of Law in New York*, 40 TAXES 263 (1962); Patterson, *Current Tax Problems in Compulsory and Voluntary Unitization*, 1961 TULANE 10TH TAX INSTITUTE 249; Pesin, *Professional Associations Doing Business as Corporations*, 21 N.Y.U. INST. ON FED. TAX. 565 (1963); Quinby, *The Kintner Regulations*, 104 TRUSTS & ESTATES 197 (1965); Ray, *A Comparison of Tax Benefits Available Under H-R 10 With Those Provided by Professional Associations*, 26 GA. B.J. 269 (1964); Ray, *Corporate Tax Treatment of Medical Clinics Organized as Associations*, 39 TAXES 73 (1961); Smith, *Associations Classified as Corporations Under the Internal Revenue Code*, 34 CALIF. L. REV. 461 (1946); Snyder & Weckstein, *Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons*, 48 CORNELL L.Q. 613 (1963); Sarnier, *Associations Taxable as Corporations: A Review and a Look Ahead*, 1962 N.Y.U. 10TH INST. ON FED. TAX. 609; Stavole, *Corporate Employee Tax Status for the Professional Man*, 11 CLEV.-MAR. L. REV. 176 (1962); Vesely, *The Ohio Professional Association Law*, 13 W. RES. L. REV. 195 (1962); Waisel, *Attorneys' Federal Income Taxes*, 66 DICK. L. REV. 75 (1961); Williams, *Medical and Dental Corporations: A*

serve to relate the discussion of various points in this article to an organization in a particular jurisdiction.

First is the professional association, found in 10 states.⁷ In this article the Georgia statute is discussed.⁸ It provides that two or more persons licensed to practice a profession under the laws of Georgia may form a "professional association," which is "an unincorporated association"⁹ "governed" by an elected board of governors who need not be members.¹⁰ The association may hold property in its own name and sue or be sued in its own name.¹¹ Articles of association are to be filed with the county clerk of court and can be amended by two-thirds of the members.¹² No member has power to bind the association.¹³ The association shall be an entity independent of its members and will continue notwithstanding the death, retirement, etc. of members;¹⁴ no member acting alone has the power to dissolve the association.¹⁵ The association may issue stock or certificates of evidence of ownership which shall be freely transferable, except as restricted in the articles.¹⁶ Only licensed professionals may own stock,¹⁷ except an estate of a shareholder for a reasonable time.¹⁸ The association may render professional services only through employees who are licensed for the professional service to be per-

Step Toward Tax Equality, 15 ARK. L. REV. 366 (1961); Williams & Cowart, *Federal Income Tax Advantages for Professionals—The Georgia Professional Association Act*, 12 MERCER L. REV. 388 (1961); Wise, *Business Life Insurance: Tax-Deferred Annuities for Employees of "Section 501(c)(3) Organizations"*; *Association of Professional Men Taxable as Corporation*, 18 N.Y.U. INST. ON FED. TAX. 461 (1960); Zarky, *Unincorporated Organizations Taxable as Corporations*, U. SO. CAL. 1961 TAX INST. 277; Comment, *Professional Associations and Professional Corporations*, 16 SW. L.J. 462 (1962); Note, 43 B.U.L. REV. 107 (1963); Note, 75 HARV. L. REV. 776 (1962); Note, 11 HOW. L.J. 188 (1965); Note, 46 IOWA L. REV. 844 (1961); Note, 12 STAN. L. REV. 746 (1960); Note, 31 U. CINC. L. REV. 71 (1962).

7. Illinois, Alabama, Georgia, Pennsylvania, South Carolina, Virginia, Ohio, Connecticut, Tennessee, Texas. The laws are collected in 1 CCH PENSION PLAN GUIDE (2d ed.) ¶¶ 9000-105 (1965). The Texas version is not similar to the others.

8. GA. CODE ANN. ch. 84-43 (Supp. 1963).

9. GA. CODE ANN. § 84-4302(b) (Supp. 1963).

10. GA. CODE ANN. § 84-4308 (Supp. 1963).

11. GA. CODE ANN. § 84-4316 (Supp. 1963).

12. GA. CODE ANN. § 84-4304 (Supp. 1963).

13. GA. CODE ANN. § 84-4308 (Supp. 1963).

14. GA. CODE ANN. § 84-4309 (Supp. 1963).

15. *Ibid.*

16. GA. CODE ANN. § 84-4310 (Supp. 1963).

17. *Ibid.*

18. *Ibid.*

formed.¹⁹ If an employee or shareholder becomes disqualified to render professional services in the state, he must sever all his connections with the association;²⁰ if he does not, grounds exist for forfeiting the association's right to practice and the secretary of state would have power to seek dissolution.²¹ Limited liability is covered in a provision stating that the members are not individually liable for "debts of, or claims against the professional association unless such member or shareholder has personally participated in the transaction."²² This provision, and some vague language about not changing the relationship between a professional and client or patient, are discussed below more extensively.²³ Groups organizing under the Georgia statute will style themselves "professional association," or "P.A."²⁴

The second type, the professional corporation, is provided for by legislation in 24 states.²⁵ The Minnesota version²⁶ for doctors provides that one or more persons licensed to practice medicine (there is a similar law for lawyers)²⁷ "may form a corporation" under the Minnesota Business Corporation Act.²⁸ The corporate name must end with "Chartered," "Limited," "Ltd.," "Professional Association" or "P.A."²⁹ The group must obtain a corporate charter in the normal way,³⁰ but the corporation may not provide professional services until a certificate of registration is given by the State Medical Board.³¹ Shares of stock may be owned only by persons who are licensed to practice medicine in the state and may be transferred only to such persons.³² The

19. GA. CODE ANN. § 84-4306 (Supp. 1963).

20. GA. CODE ANN. § 84-4311 (Supp. 1963).

21. *Ibid.*

22. GA. CODE ANN. § 84-4307 (Supp. 1963).

23. Text accompanying notes 395-403 *infra*.

24. GA. CODE ANN. § 84-4304 (Supp. 1963).

25. Arizona, Arkansas, Florida, Idaho, Illinois, Indiana, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, North Dakota, Oklahoma, Rhode Island, South Dakota, Utah, Vermont, West Virginia, Wisconsin. The laws are collected in 1 CCH PENSION PLAN GUIDE (2d ed.) ¶¶ 9000-105 (1965). Note that Illinois also has an association statute. See note 7 *supra*.

26. MINN. STAT. §§ 319.01-.23 (1961).

27. Minnesota Attorneys Professional Corporation Act, MINN. STAT. ANN. §§ 319.26-.41 (Supp. 1964).

28. MINN. STAT. §§ 301.01-.84, 319.03 (1961).

29. MINN. STAT. § 319.06. (1961).

30. MINN. STAT. § 319.05 (1961).

31. MINN. STAT. § 319.07 (1961).

32. MINN. STAT. § 319.18 (1961).

board may revoke this certificate of registration,³³ (but only after notice, hearing and opportunity for appeal)³⁴ for such events as the revocation of the license of an employee. The corporation may render professional service only through licensed doctors.³⁵ Liability is limited.³⁶

The third approach is that adopted in Colorado where a rule of civil procedure provides that attorneys may practice in the corporate form provided certain requirements are met concerning the persons who own stock, adequate malpractice insurance, etc.³⁷

The precise issue in this article is the formulation and application of criteria for classifying these business organizations for federal income tax purposes. The traditional sources of authority — legislative history, judicial decisions, and treasury regulations — bear examination to determine how they solve this problem. Some criticisms of the solutions provided will be offered with a suggested framework for resolving these cases.

In this investigation, it will be helpful to examine the impact of the various tests and authorities on several models, or hypothetical situations:

(1) *Professional association* — a group of about 10 doctors organized and practicing under the Georgia statute discussed herein.

(2) *Professional corporation* — a group of 10 doctors organized in Minnesota.

(3) *Colorado profession corporation* — a professional corporation composed of 10 lawyers organized without any specific enabling legislation but subject to certain state supreme court rules.

(4) *Personal service corporation* — a corporation organized by 10 individuals in the business of management consulting.

(5) *Manufacturing corporation* — a small manufacturing corporation with 10 shareholders and 20 employees.

I. THE STATUTE AND LEGISLATIVE HISTORY

As one might expect, nothing in the words used in the present statute, discussed below, or in the legislative history compels one result or another in this controversy. But some history and some indication of Congress' meaning is available.

33. MINN. STAT. § 319.12 (1961).

34. MINN. STAT. §§ 319.13–.14 (1961).

35. MINN. STAT. § 319.15 (1961).

36. MINN. STAT. § 319.16 (1961); see text accompanying notes 214–17 *infra*.

37. COLO. R. CIV. P. 265.

A. PRIOR REVENUE LAWS

The earliest revenue acts demonstrated some recognition of the various forms of doing business.³⁸ The partnership and corporation were treated similarly, although certain corporations were given some collection or withholding duties not imposed upon partnerships.

The revenue act of 1894,³⁹ which imposed a two percent income tax on individual⁴⁰ and corporate income,⁴¹ is the beginning of more significant history on the question of classification of businesses into different groups for purposes of federal income taxation. Individual income received a \$4,000 exemption,⁴² but not corporate income. Consequently all of a corporation's income was taxable. Since an individual received an exclusion for dividends from a corporation that had paid the two percent tax, no "double"

38. The first income tax law, Act of Aug. 5, 1861, ch. 45, 12 Stat. 292, imposed an income tax upon "the annual income of every person residing in the United States," § 49, 12 Stat. 309 (1861). "Person" apparently meant "individual" as that term is now used in the Internal Revenue Code. Corporations as such were not taxed, although a "person's" income from dividends was.

The Act of July 1, 1862, ch. 119, § 89, 12 Stat. 473, repealed the act of 1861. Section 57 of the 1862 act imposed a license tax on every person, association of persons, or corporation engaged in designated trades or businesses. 12 Stat. 453 (1862). Congress thus referred to various forms of doing business and apparently included partnerships in "association of persons." Section 82, 12 Stat. 470 (1862), imposed a "duty" of three percent on dividends of banks and insurance companies as a type of withholding scheme. Section 91, 12 Stat. 473 (1862), supported Section 92, 12 Stat. 474 (1862), which imposed an income tax on the "income of every person residing in the United States."

The Act of June 30, 1864, ch. 173, 13 Stat. 223, imposed a license tax on a "person, firm, company, or corporation." Section 71, 13 Stat. 248 (1864). In 1870 the income tax was reduced, ch. 255, § 6, 16 Stat. 256, and in 1872 it expired and was not renewed. PAUL, *TAXATION IN THE UNITED STATES* 27 (1954).

39. Act of Aug. 27, 1894, ch. 349, 28 Stat. 509.

40. Ch. 349, § 27, 28 Stat. 553 (1894).

41.

That there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income above actual operating and business expenses, including expenses for materials purchased for manufacture or bought for resale, losses, and interest on bonded and other indebtedness of all banks, banking institutions, trust companies, saving institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric-light, gas, water, street railway companies, and *all other corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.*

Ch. 349, § 32, 28 Stat. 556 (1894). (Emphasis added.)

42. Ch. 349, § 27, 28 Stat. 553 (1894).

taxation of corporate income resulted.⁴³

The question of which business organizations were subject to the two percent tax was important to an individual with income of less than \$4,000 and who also received dividend income from a corporation which had paid the tax. He could not get a refund of that tax, and, of course, exclusion of the income received from the corporation meant nothing to him since his income was below the \$4,000 exemption level anyway.

On the other hand partnerships were not taxed, although income from a partnership was.⁴⁴ Therefore, anyone receiving income from a partnership could take the full \$4,000 exemption, but an individual receiving dividends from "corporations, companies, or associations" could not if his other income was less than \$4,000.

The decision to tax income of corporations and to exclude income of partnerships from the two percent tax was quite deliberate. Some members of the Senate may have thought "associations" referred only to organizations calling themselves associations and organized under a state law as such, but others who thought the term "association" had a meaning broad enough to include partnerships prevailed in carving out an exception for partnerships by adding the words "but not including partnerships" to the section under consideration.⁴⁵ Whatever the meaning

43. Ch. 349, § 28, 28 Stat. 553 (1894).

44. See note 41 *supra*.

45. 26 CONG. REC. 6877 (1894) (remarks of Mr. Hoar and the Secretary). Because § 32 as originally proposed did not include that phrase, the following discussion occurred on the floor of the Senate:

Mr. HALE. It applies to almost every form of human industry. It is the fashion now instead of making a partnership to form these little associations and put in twenty-five, forty, or fifty thousand dollars. They ought to be encouraged rather than discouraged.

Mr. HOAR. This does not include partnerships. It applies only to companies, corporations, or associations, not partnerships.

Mr. HILL. It makes a discrimination against corporate investments.

Mr. ALDRICH. I should be glad to have the Senator from Missouri state whether the interpretation given to this bill by the Senator from Massachusetts in his opinion is a correct one, because if the word "association" here includes partnerships, as the Senator from Massachusetts stated, as I understand —

Mr. HOAR. I did not say that.

Mr. ALDRICH. That is what I understand the Senator to say.

Mr. HOAR. I said "companies."

Mr. ALLISON. I do not understand, and I should be glad to have the Senator from Missouri state, whether he understands that this section and the subsequent sections regulating this subject are intended to deal with anything but associated corporations?

Mr. VEST. That is the meaning of it. I have not had any doubt it. If I had intended to use the word "partnerships," I should have said

"partnerships." For instance, take building and loan associations. That is the way they style themselves. They are not called "companies"; they are not called "corporations" *eo nomine*, but they are called "associations." Two or more individuals associate themselves, and we have a chapter in the Revised Statutes of Missouri which provides for these associations. They are quasi corporations.

Mr. HALE. That is not a private business partnership.

Mr. VEST. No; that is not a partnership.

Id. at 6833.

In spite of Senator Vest's assurances, obviously there was some doubt whether partnerships were included. Later the following exchange took place:

Mr. HOAR. I should like to inquire of the committee, in order to make clear what I understand they say is their meaning, whether there is any objection to adding after the word "organized" the words "but not including partnerships?" I am afraid that the phrase "companies or association" . . . "no matter how created and organized," does include partnerships.

Mr. VEST. This language is taken from the act of 1864. That act uses the words "corporation or association."

Mr. HOAR. Not "companies?"

Mr. VEST. Yes, "companies, corporations, or associations."

Mr. HOAR. If the Senator has that clause in the act before him, I should like to have him read it.

Mr. VEST. Here is the language to which I referred. It is in the act of the Thirty-eighth Congress, first session, chapter 173 "manufactures, articles, and products." This is not the income tax law, but it is what is call [*sic*] the excise law, the manufactures law:

SEC. 82. *Be it further enacted.* That every individual, partnership, firm, association, or corporation—

Mr. HOAR. Exactly.

Mr. HOAR. That act uses the word "partnership" and in terms it includes individuals.

Mr. VEST. The words were "every individual, partnership, firm, association, or corporation."

Mr. HOAR. It does not say "company." It is not the purpose of this section to include partnerships. They are dealt with in another way, and the exemption belonging to the individual partner is to be secured in another way.

I should like to ask my friend from Missouri, who is a good lawyer and does not want to draw a bill and be responsible for an act that has doubt in its meaning, whether it is not better to make his meaning clear, and whether it is not, to say the least, a doubtful question whether the clause "corporations, companies, or associations doing business for profit in the United States, no matter how created and organized," does not include partnerships?

I say on my responsibility as a lawyer that I think it does. I should give that opinion as at present advised to a client or to an officer of the Government. *I cannot conceive a more apt description of a partnership than "companies or associations doing business for profit." If a partnership is not a company or association of men doing business for*

of "association" in those days, clearly Congress did not want partnerships treated the same as "associations." This amending clause raises the classification problem, although neither the statute nor its history provides a definition of a partnership.

Legislative history also provides some discussion of the uses of corporations in that era. Small, closely held corporations were very well known and businessmen generally could choose either the partnership form or the corporate form for doing business. Over and over again legislators recognized that corporations were formed to provide *limited liability* and *avoidance of dissolution* upon the death, retirement, etc. of a partner, although apparently no one mentioned transferability of interests or centralization of management.⁴⁶

profit what in the world is it, however established or organized? The clause is made clear to everybody by simply adding the words, "and not including partnerships," and that is what I suggest to the consideration of the Senate. I gave notice of that amendment. I shall not offer it at this moment because I want to offer another.

Id. at 6835. (Emphasis added.)

46.

Mr. HOAR. . . .

In my State it is the almost universal practice, and it is a practice which has grown up in England under what they call corporations or associations of limited liability, to go into a joint stock company. Two or three youngsters just out of their apprenticeship go into partnership together and do some little portion of the work of a machine shop. I could name several such establishments in my own city. One is a concern manufacturing particular kinds of toys, and another engaged in the manufacture of bicycles in a small way. And so it is in business of all sorts and kinds, partly, I suppose, because it involves legal safeguards, but the chief reason is that when one of the partners dies or goes out of the company for any reason, the survivors in the corporation do not have to liquidate the concern, and wait a year or two and go through a process of law before they can go on with the business.

That has become, I say, the almost universal mode of doing every kind of little business. There will sometimes be salaries. There will be a frugal salary for the president and the vice-president and the treasurer, but they leave in the concern all they make and go on with it except to derive from it sufficient for a frugal living.

Id. at 6866. "Mr. VEST. Men go in and make up a corporation in order to escape individual liability." *Id.* at 6867.

Mr. HOAR. There are in my State, and I suppose in nearly all the States now, an enormous number of persons who form themselves into what are called joint stock companies, but which are corporations in the law for two purposes, first to escape the personal liability for debt beyond the limit fixed, whatever it may be, and, next, so that whenever a single partner goes out or dies or becomes insolvent on his private account, or anything else which would dissolve the corporation, there is not to be a legal liquidation of the whole concern. These two latter

Aware of only small differences in form and the option by business owners to choose one form or the other, Congress nevertheless enacted a tax law with different consequences, depending on whether the owners used the form of a partnership or of a corporation. The income tax of the 1894 act was held unconstitutional by the Supreme Court in *Pollock v. Farmers' Loan & Trust Co.*⁴⁷

In 1909 a tax was levied upon the privilege of doing business under certain forms.⁴⁸ A one percent tax on all net income over \$5,000 was provided for "... every corporation, joint stock company or association, organized for profit and having a capital stock

are quite as important as the former.

Id. at 6833.

Mr. PLATT. . . .

. . . . This bill does not tax the income of a partnership; and the corporations of this country, when you step outside of those which are continually in the mind of the people and which are exciting the criticism of people, are nothing more than commercial partnerships.

. . . .
Mr. HAWLEY. If my colleague will permit me, we remember, both of us very well, that some thirty years ago when our joint stock corporations laws were enacted in Connecticut, it was then supposed, and even is now, that it is an enormous advantage to the men of limited means, three, four, or five in number, who, with a thousand dollars apiece, can organize and safely conduct business. It is a special blessing to the poor man.

Mr. PLATT. . . .

Mr. President, when it comes to my own State it strikes an entirely different class of people and an entirely different class of corporations—corporations engaged in as honest and legitimate business as the merchant who has a retail store or the individual who is printing a country paper, or the mechanic who has been enabled to get a small shop and carry on a small manufacturing business.

Id. at 6704. And then there was a prediction which did not quite come true.

Mr. PLATT. . . .

We shall have no more joint stock corporations formed in the State of Connecticut if business carried on in other forms is to be discriminated in favor of and they are to be discriminated against. If on one side of a street three persons carry on business as partners, making a joint profit of \$6,000, no income tax is to be paid upon such income or profit unless the partners have other sources of income which, added to their share of the partnership gains, makes their individual income exceed \$4,000. If on the opposite side of the street three persons, having formed a corporation carry on the same kind of business and make the same amount of profit, the \$6,000 profit made by the corporation is to pay an income tax of \$120. Is this equal taxation?

Id. at 6705.

47. 157 U.S. 429 (1895).

48. Act of Aug. 5, 1909, ch. 6, 36 Stat. 11.

represented by shares”⁴⁹ Partnerships were apparently excluded and associations clearly included by the language which closely resembled that used in earlier tax statutes. The act was sustained.⁵⁰

Continued recognition of some different *forms* for organizing to do business is shown in the revenue act of 1913.⁵¹ A normal tax was imposed upon the net income of “every person,”⁵² and a graduated surtax was imposed on incomes over \$20,000.⁵³ Passage of the sixteenth amendment made a national income tax possible. The normal tax was also imposed upon “every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships”⁵⁴ Different treatment of partnerships appears again. The difference continued to be slight, however. A deduction from income for purposes of determining taxable income was authorized for “the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided”⁵⁵ Partners were to be taxed upon partnership income: “any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise”⁵⁶ Consequently partners and shareholders were treated alike, in the end, unless their total income was less than \$4,000 (for a married couple). The shareholder with income under \$4,000 could not derive any benefit from the

49. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 112.

50. The act was held constitutional as an excise tax on business done in the corporate form, not as a direct tax. *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

51. Act of Oct. 3, 1913, ch. 16, 38 Stat. 166.

52. Ch. 16, § II. A. Subdivision 1, 38 Stat. 166 (1913).

53. Ch. 16, § II. A. Subdivision 2, 38 Stat. 166 (1913). For purposes of the surtax:

the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax

Ibid.

54. Ch. 16, § II. G(a), 38 Stat. 172 (1913).

55. Ch. 16, § II. B, 38 Stat. 167 (1913).

56. Ch. 16, § II. D, 38 Stat. 169 (1913).

tax paid by the corporation on its income, whereas the partnership paid no tax as such.

In the Revenue Act, 1916, the difference for tax purposes between carrying on a business in one form or another took on substantial importance. A normal tax was imposed on "every individual"⁵⁷ and a graduated surtax on incomes over \$20,000.⁵⁸ Instead of a deduction from taxable income for dividends on which a corporation had paid a tax, a deduction for the normal tax only was allowed for dividends from a corporation which had been taxed. No such deduction, however, was available for the surtax. Consequently, income from corporate dividends was taxed "twice," once at the corporate level,⁵⁹ and again at the shareholder level for the surtax.

In all these revenue acts no *definitions* of the terms person, individual, partnership, association, and corporation were given. However, some "definitions" did appear in the Revenue Act of 1918: "The term 'person' includes partnerships and corporations, as well as individuals; the term 'corporation' includes associations, joint-stock companies . . ."⁶⁰ The War Excess Profits Tax, under the 1917 act, had also defined "corporation" similarly: "The term 'corporation' includes joint-stock companies or associations and insurance companies . . ."⁶¹ The tax was imposed "upon the income of every corporation, partnership, or individual . . ."⁶² This marks the beginning of the practice of including "associations" under the category of "corporations" in drafting.

It is somewhat startling to find in the 1918 act a definition for and special treatment of a "personal service corporation":

The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor . . .⁶³

Personal service corporations were treated as partnerships.⁶⁴

57. Revenue Act, 1916, ch. 463, § 1(a), 39 Stat. 756.

58. Ch. 463, § 1(b), 39 Stat. 756 (1916).

59. Ch. 463, § 10, 39 Stat. 765 (1916).

60. Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057.

61. War Revenue Act, ch. 63, § 200, 40 Stat. 302 (1917).

62. Ch. 63, § 201, 40 Stat. 303 (1917).

63. Revenue Act of 1918, ch. 18, § 200, 40 Stat. 1059 (1919).

64.

(e) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so

Section 218(a) specified the treatment of partnerships: "That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not" ⁶⁵ The personal service corporation, however, had a short life span. The Revenue Act of 1921 repeated the provision on personal service corporations, but stated that those sections would not be in effect after December 31, 1921. ⁶⁶

far as practicable apply to personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares. Ch. 18, § 218(e), 40 Stat. 1070 (1919).

65. Ch. 18, § 218(a), 40 Stat. 1070 (1919). See S. Doc. No. 391, 65th Cong., 3d Sess. 3 (1919): "A personal service corporation has been relieved from the payment of tax as a corporation, and only taxed through the income tax upon the stockholders thereof upon the basis of an actual distribution of the entire income of the corporation." There was also a proposal in the collected legislative history for something like the present subchapter S. Notes on the Revenue Act of 1918 (pt. I), Submitted by the Secretary of the Treasury Without Recommendation 5-7 (1919).

66. Revenue Act of 1921, ch. 136, § 218(d), 42 Stat. 245. The reasons for this quick turn about are obscure, but may relate to the following passage in the Senate Report:

ALTERNATIVE TAX ON PERSONAL-SERVICE CORPORATIONS

Section 1332 provides that in case the present method of taxing personal-service corporations (i.e., on the same basis as partnerships) is declared unconstitutional such corporations shall be taxed for the years 1918 to 1921, inclusive, upon the same basis as other corporations. . . .

This section is deemed advisable because the stock-dividend decision has cast doubt upon the constitutionality of the provisions of the revenue act which treat personal-service corporations substantially as partnerships.

SENATE COMM. ON FINANCE, 67TH CONG., 1ST SESS., REPORT ON INTERNAL REVENUE BILL OF 1921, at 34 (Comm. Print No. 2, 1921).

Probably the special treatment of personal service corporation was dropped as less necessary because of the reductions in tax rates following the war. Section 1332 was designed to protect the tax base during the period of special treatment of personal service corporations in case of a judicial overturning of the special provision concerning personal service corporations. It is also possible that the "doubt" concerning the constitutionality of these sections contributed to repeal of the special treatment.

The Senate Report stated:

Section 218 is the same as the corresponding provision in existing law except that proper provision is made for the repeal, as of January 1,

The appearance for a short time of the personal service corporation is significant since Congress thus recognized the existence of, presumably, a substantial number of personal service businesses conducted under the form of a corporation. Apparently it was thought that these businesses should be treated the same as *partnerships* for one reason or another. Certainly no doubt remains, if history is any guide, that there can be, for federal income tax purposes, personal service corporations treated as *corporations*.

The definitions provided by the Revenue Act of 1918 are just as circular as the earlier lack of definitions.⁶⁷ But this revenue

1922, of the tax on the stockholders of a personal-service corporation with respect to undistributed profits in such corporation and the taxation [thereafter] of such corporation in the same manner as other corporations are taxed.

SENATE COMM. ON FINANCE, 67TH CONG., 1ST. SESS., REPORT ON INTERNAL REVENUE BILL OF 1921, at 14 (Comm. Print No. 1, 1921).

67. The enactment of these "definitions" did provide the setting for some more legislative conversation on the definitional problem. The question of what is a corporation came up on connection with a discussion of charitable contribution and what forms of organization were included in gifts to a "corporation":

Mr. GARNER. The gentleman will find the definition of "corporations" on page 1 of the bill to include associations, joint-stock companies, and insurance companies, as well as private corporations. The term "corporation" embraces any kind of an association to which an individual makes a donation.

Mr. BORLAND. I take it that the word "corporation" would include an organization which had a legal entity. It would not include an association in the ordinary sense—a club or a society.

...
Mr. BORLAND. We have a board of public welfare which is conducted by men who serve without pay. They are appointed by public authorities. They do collect quite a fund.

Mr. CANNON. Are they incorporated?

Mr. BORLAND. No.

Mr. CANNON. Are they included[?]

Mr. GARNER. They would be if they are an association of people. It makes no difference whether they are incorporated, if they are an association of people. Let the gentleman turn to the definition of "corporation" on page 1 of the bill which I just read. What is an association? It is a number of people who are associated together.

Mr. CANNON. The gentleman is sure that would change it.

Mr. GARNER. We undertake to do it in the definition here.

Mr. BORLAND. The word "corporation" ordinarily means a legal entity.

Mr. GARNER. I know, but we have changed it. We have undertaken to determine what a corporation is by stating specifically what it includes, and we say that it includes an association. Now, if you want

to go to the dictionary and find out the definition of association, well and good. I think it means a number of people, whether organized under law or voluntarily.

56 CONG. REC. 10418 (1918).

That discussion is not very helpful since nowhere was there a discussion of what is a *partnership*, and the effect of a gift to a partnership. It is unlikely, however, that the partnership form would have been used for such a purpose. The discussion does indicate a broad concept of "association" and does provide the occasion for examining the dictionary, as was suggested in the exchange.

BLACK, A DICTIONARY OF LAW 100 (1st ed. 1891), defines an association as follows:

ASSOCIATION. The act of a number of persons who unite or join together for some special purpose or business. The union of a company of persons for the transaction of designated affairs, or the attainment of some common object.

An unincorporated society; a body of persons united and acting together without a charter but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise.

1 BOUVIER, LAW DICTIONARY 269 (8th ed. 1914) states:

ASSOCIATION: The act of a number of persons in uniting together for some purpose. The persons so joining.

An organized union of persons for a common purpose; a body of persons acting together for the promotion of some object of mutual interest or advantage. Cent. Dict.

Any combination of persons whether the same be known by a distinctive name or not. Stroud, Judicial Dictionary.

An unincorporated company is fundamentally a large partnership, from which it differs mainly in the following particulars: That it is not bound by the acts of the individual partners, but only by those of its managers; that shares in it are transferable; and that it is not dissolved by the retirement, death, bankruptcy, etc., of its individual members; Dicey, Parties 149.

In the United States this term is used to signify a body of persons united without a charter but upon the methods and forms used by incorporated bodies for the prosecution of some enterprise. Abbott, L. Dict.

5 C.J. *Associations* § 1 (1st ed. 1916) has an extensive article on associations:

A. Definition. . . . As the term is commonly used, however, an "association" may be defined to be a body of persons acting together, without a charter, but upon the methods and forms used by incorporated bodies, for the prosecution of some common enterprise. . . .

B. Corporation Distinguished. The term "association" frequently enters into the names bestowed upon corporations by the legislature or chosen by the incorporators themselves; and in its broad sense it may include "corporation." So the term as employed in statutes is frequently held, by reason of the object and scope of the statutes, to include "corporations," or to be synonymous therewith. Ordinarily, however, the two terms are employed to denote different and distinct conceptions; and the term "association" is generally used in a restricted sense as relating to unincorporated societies. . . .

act does mark the beginning of the present way of "defining" these terms, *i.e.*, by having the word "person" refer to several categories of taxpayers, whether persons or not, and by having the word "corporations" include entities that are not corporations under local law, namely associations.⁶⁸

The Revenue Act of 1932⁶⁹ finally provided a "definition" for the term "partnership":

C. Joint Stock Company Distinguished. The term "association" may include "joint stock company," but it does not necessarily include that term, and strictly speaking is not applicable thereto, since a voluntary association cannot issue stock, and the right of membership is not transferable, at least not without the consent of the association itself.

D. Partnership Distinguished. It has been said that the word "association" is a generic term which may properly comprehend a partnership as well as a corporation. Strictly speaking, however, an unincorporated association is neither a partnership nor, it has been said, a quasi partnership, although it is rated as a partnership so far as its capacity to sue and to be sued is concerned. In any event, the members thereof, whatever may be their relation and liability to third persons dealing with the association, are not partners *inter sese*, since the death of a member does not of necessity work a dissolution of the association, and there exists no authority in a single member to bind the others. . . . Where, however, the association is organized for commercial purposes, and operated for pecuniary profit, it is no more than a partnership, and the rights and liabilities incident to that relation attach to its members, as well between the members themselves, as between a member and the association, and as between members and third persons dealing with them or the association.

Corpus Juris goes on to point out that associations may be formed in some states under specific statutes and generally, under the common law, by contract, generally embodied in an instrument called article of association. 5 C.J. *Associations* §§ 5-6 (1st ed. 1916).

Ruling Case Law contains nothing but cross reference to "Mutual Benefit Societies; Religious Societies; Societies and Clubs." 2 R.C.L. 740 (1914).

4 CYCLOPEDIA OF LAW AND PROCEDURE 299-316 (1902) contains some materials on "Associations." It begins with the Black, *Law Dictionary* definitions. The articles states that a single member has no power to bind the association, *id.* at 310, and each member of an association is liable for debts of its association incurred during his membership, *id.* at 311, and for torts of the association, *id.* at 312.

All these definitions have in common both vagueness and lack of an answer to the characterization question—for what purpose is the question, "what is an association," asked. They all seem dependent upon labels, and self-serving characterizations found in charters, or documents. It could be concluded that there were no sophisticated distinctions in mind when the words "associations," etc., were used in these "definitions." Probably the Congress had no precise notion of what these concepts meant except as loose terms referring to certain well known forms of doing business.

68. See text accompanying note 73 *infra*.

69. Ch. 209, 47 Stat. 169.

(3) The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.⁷⁰

This definition is just as circular as ever. Literally, all associations might be partnerships. The House Ways and Means Committee *Report* provides some meaning for the change:

Some confusion has existed over the requirements of the prior acts as to the time and manner of returning income from the operations of joint ventures, syndicates, pools, and similar organizations. If the syndicate was not an association, partnership, or trust within the meaning of the act, there was no express requirement in the act or regulations for the filing of a syndicate return, and the sole responsibility of making returns of the annual gains and losses of the syndicate was placed upon the several members. Quite frequently, however, the members of such a syndicate overlooked the necessity of their making returns each year of their shares in the annual gains and losses from syndicate operations and assumed that they were required only to make returns of their shares in the ultimate gain or loss from the entire syndicate operations in the year when the syndicate was wound up or liquidated. Moreover, a strict observance of the letter of the prior acts would have required each member to determine his annual share in the syndicate gains or losses upon the basis of his own accounting period and according to his own method of accounting, irrespective of the accounting period or method of accounting upon which the books or records of the syndicate were kept.

The bill does away with this uncertainty by placing all joint ventures, syndicates, pools, and similar organizations, which do not constitute associations or trusts, in the category of partnerships, and the members of such syndicates, pools, etc., in the category of partners. This provision will have the effect of requiring the syndicate to file an information return similar to the return of a partnership and will thus make it easier for the members to determine the distributive shares in the syndicate gains and losses which are to be included in their own returns.⁷¹

This passage has some significance. Since the term "association" appears to have had such a broad meaning, it now appears a little odd that syndicates and joint ventures then fell in between the terms "partnership" and "association." Yet the Congress intended that such groups were not associations. Apparently, then, an association was either a group calling itself an association, or one formed under an association statute. The dictionary defi-

70. Section 1111(a)(3), 47 Stat. 289 (1932).

71. H.R. REP. NO. 708, 72d Cong., 1st Sess. 53 (1932).

nitions of the time are generally consistent with that approach.⁷² At any rate, the importance of the local law characterization by mere label is again apparent. But there is no guide for marginal cases. In all the legislative history the importance of the label "corporation" is also evident. It was assumed that every business organization operating under a charter bearing the title "corporation" is a corporation as that term is used in the various statutes discussed herein.

B. CURRENT CODE PROVISIONS

The relevant Code sections now provide:

§ 7701. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) Person. The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company, or corporation.

(2) Partnership and partner. The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) Corporation. The term "corporation" includes associations, joint-stock companies, and insurance companies.⁷³

The definitions are still circular. "Corporation" includes "associations"; a "partnership" is a business which is not a "corporation" (or an association). But nowhere are there criteria for what is one or the other.

The dependence on *something* outside these bare "definitions" is obvious. It may reasonably be assumed that Congress had little doubt that local law labels would suffice. In later years, the earlier drafted sections and "definitions" were merely repeated. Yet the concept of federal characterization for federal income tax purposes was developing. Now, in the name of that principle, almost any result is possible.

The legislative history and the early laws do show that corporations were used mainly to provide limited liability and to give continuity of life to the business form, at least, and perhaps even to prevent discontinuity of the business itself. Associations seemed to have the latter characteristic and usually were businesses calling themselves "association" or organized under an association statute.

Taking the plain words meaning of the statute and whatever

72. See note 67 *supra*.

73. INT. REV. CODE OF 1954, § 7701(a)(1)–(3).

legislative history can be found, the conclusion can be reached that local law characterization was actually intended. Thus, a partnership under local law is a partnership, and an association or a corporation under local law is a corporation, for purposes of the Code's definitions of those terms. To be sure, the vagueness of the definition and the lack of criteria made it possible to argue for another conclusion. If any substantial, relevant, and valid federal policy requires the use of other criteria, of course they might be imposed upon the Code's circular structure.

C. OTHER LEGISLATIVE HISTORY

Other sections of the Code, and their history, may have some bearing upon the question of what is a corporation for federal income tax purposes. A number of requests have been made to Congress to equalize the benefits of the self-employed and the employed. These requests have met with varying success.

Subchapter R permits certain unincorporated businesses to elect to be taxed as corporations.⁷⁴ This provision supposedly allows a business "to select the form or organization which is most suitable to its operations without being influenced by Federal income-tax consideration."⁷⁵ This section was enacted with knowledge that the legal, medical and other professions could not practice in the corporate form and that this innovation would not help those groups, for it is limited by its terms to enterprises which are engaged in certain trading activities or in which "capital is a material income-producing factor."⁷⁶ The enactment of subchapter R probably indicates nothing of how Congress believes medical and legal groups *should* be taxed, except to show awareness that a problem exists. But this awareness has existed for a long time, and Congress has done nothing one way or the other directly bearing on section 7701. Even if subchapter R is not evidence of congressional interest in the problem herein discussed, it certainly does not preclude interpretation of section 7701(a)(3) to recognize these professional "associations" and "corporations" as corporations for federal income tax purposes.

The enactment of subchapter S,⁷⁷ providing the option for certain corporations to elect to pass income and losses through to

74. INT. REV. CODE OF 1954, § 1361.

75. S. REP. NO. 1622, 83d Cong., 2d Sess. 119 (1954).

76. INT. REV. CODE OF 1954, § 1361(b)(4). This section is really not much help for most partnerships, however, since a partner of a firm making an election under § 1361 cannot be an "employee" for purposes of the various deferred compensation plans for employees. INT. REV. CODE OF 1954, § 1361(d).

77. INT. REV. CODE OF 1954, §§ 1371-77.

the shareholders, was intended to give some taxpayers the option of using the corporate form without having the disadvantages of taxation as a corporation. This is another indication of legislative policy to permit *some* taxpayers to choose their form for tax purposes, by election.

HR 10, intended to provide some tax benefits to self-employed individuals adopting a pension or profit sharing plan, is additional evidence of congressional knowledge of and interest in a slight reduction of the disparity in treatment of the employees of corporations and the "self-employed."⁷⁸

Of course HR 10, subchapter S, and subchapter R did not wholly eliminate the existing inequities, and, indeed, Congress did not go as far as requested by those sponsoring the bills. Congress perhaps did not want to grant more relief (which seems unlikely when one looks at the trend); more likely, considering the practical problems of seeing legislation through to enactment (including Treasury sponsored restrictions and often general resistance), it could not do better at the time. Moreover, Congress was aware, during the discussion and eventual approval on October 16, 1962, of HR 10, that the Kintner Regulations, discussed below, were in effect, and that over 30 states had passed laws enabling professionals to organize as associations or corporations. The enactment of HR 10 shows nothing one way or the other as to any express congressional intent on the treatment of these professional associations and corporations. Note, however, that the Treasury Department could have asked for clarification of their status through legislation, but apparently did not. This inaction could indicate that the Treasury was too busy with other legislation, or it may indicate that the Treasury Department thought it would be fighting a losing battle.

All of this recent legislative history, therefore, proves nothing specific on the particular issue before us. However, the trend of legislation is to give more options and choices to taxpayers regarding the form for taxation and to reduce the disparity in treatment of taxpayers. If this trend were applied to the question of taxation of professional associations and corporations, the answer would be taxation according to whatever form the group adopts, absent any sham problem.

78. INT. REV. CODE OF 1954, §§ 72(n), 401(a), 401(c)-(g), 404(a)(8), 404(c), 404(f), 405, 503(j). For an excellent comparison of the tax consequences of HR 10 and corporate pension and profitsharing plans, see Snyder & Weckstein, *Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons*, 48 CORNELL L.Q. 613, 616-34 (1963).

D. APPLICATION TO THE MODEL CASES

Application of the plain words of the statute, together with the available legislative history, leads to the conclusion that all of the five models should be treated as corporations for federal income tax purposes, unless some good reason or policy appears to suggest the contrary. Each model calls itself a corporation or association and is organized under a corporation or association act. If some of these acts are not exactly like the business corporations acts of the states involved, neither are they, in substance or form, exactly like the partnership provisions. Since no compelling policy reason for one result or the other is apparent from the statute or its history, taxation of these models as corporations is appropriate, since local law so characterizes each association or corporation.

II. JUDICIAL INTERPRETATIONS

No case has been found holding that a business organized under a state corporation law, calling itself a corporation, and actually operating under that form, should be characterized other than as a corporation for federal income tax purposes.⁷⁹

Of the many cases under section 7701, some require careful examination in this article. But first it would be appropriate to report the findings of one investigator, Professor Joseph T. Sneed, on the many cases discussing the classification question under section 7701 and its predecessor sections.⁸⁰ Professor Sneed's investigation was aimed at the classification problem faced by the oil and gas industry, but this collection of data is helpful since it was not limited to cases involving that industry.

Professor Sneed finds certain "universal" facts present in all the cases holding the organization taxable as an association: (1) two or more persons or corporations pursued a common object,

79. See Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 25 (1961).

80. Sneed, *More About Associations in the Oil and Gas Industry*, 33 TEXAS L. REV. 168 (1954). Professor Sneed's method was to "study the cases, discover from their facts the ones which recur with the greatest frequency where it is held that an association exists, and prepare a list of these high-frequency facts to serve as a kind of yard stick against which doubtful business organizations may be measured." *Id.* at 186. His objective was to find when an organization bears a substantial resemblance to a corporation. He is critical of attempts to restrict relevancy by using the fewest possible characteristics which distinguish corporations from other business organizations. *Id.* at 185.

with each having a proprietary interest in whatever was to be achieved by the organization;⁸¹ (2) "the organization's purpose was to carry on a business for profit";⁸² (3) the death of the associates did not terminate the enterprise and the transfer of an interest in the organization did not terminate it;⁸³ and (4) someone acted as common agent for those associated in the venture (centralization of management).⁸⁴ In a few cases the facts were not clear about termination of the enterprise and in others the interest could not be transferred. The concept "continuity" as used in his study refers to the life of the enterprise and not to technical entity continuity.⁸⁵ Although he found these "universal" facts in the cases where the association classification was found, he points out that in no case was the existence of all of the above "universal" facts "alone sufficient to justify association classification."⁸⁶

Professor Sneed's study revealed that centralization of legal title was the most frequent of the nonuniversal facts. This centralization was found in the common agent, trustee, or in "some sort of entity or group apart from the individual association members."⁸⁷ Of 84 cases finding an association, legal title to property was clearly centralized in 78. "[S]trong arguments can be made that the equivalent of centralized title existed" in two cases. No indication was given one way or the other in the remaining four cases. Sneed concluded that centralization of title was important evidence of association status.⁸⁸

The next most frequent, though nonuniversal, fact was "a cluster of three corporate-like characteristics all of which point toward continuity of life and centralization of management."⁸⁹ The three were: "the existence of a body whose function is analogous to that of a board of directors; the authorization in the agreement to issue, or the issuance of, share certificates; and the existence of a trade name."⁹⁰

81. *Id.* at 187.

82. *Id.* at 188.

83. *Ibid.*

84. *Id.* at 189.

85. *Id.* at 189 & n.68; see *id.* at 191.

86. *Id.* at 189.

87. *Id.* at 190.

88. *Ibid.*

89. *Id.* at 190-91.

90. *Id.* at 191. Professor Sneed prepared the following table showing the frequency of these three parts of the "cluster":

Limited liability arrangements were clearly found in 45 cases; in four liability clearly was unlimited. In 21 cases the matter was not mentioned; and in 14 the facts were inconclusive.⁹¹ He does not say what was considered to be limited liability, however. Professor Sneed rightly points out that the low frequency of this factor was no surprise since the study was not of corporations but of associations. Normally, businesses get limited liability only through a corporate charter.

The other nonuniversal facts he analyzed were managerial succession, formal records, and formal voting procedure.⁹²

Sneed then analyzed his findings, concluding that among the universal and nonuniversal facts he described, one could find the "critical" facts for determining whether an association is present. He decided that while the presence of all these facts would produce the classification "association," not all the facts need be present. He then put the facts he discovered into three groups: (1) centralization of legal title; (2) limited liability; and (3) all the other facts—miscellaneous corporate characteristics.⁹³ In some cases the presence of *either* centralization of title *or* limited liability *alone* was enough to produce the association classification. Therefore, he argued that the combination of either (1) or (2) with half of the six characteristics under (3) would be an even more compelling case for classification as association. He carried his frequency analysis further: "Of the 84 cases examined, only 23 involved organizations which did not have either: (1) both centralization of title *and* limited liability, or (2) at least three of the six miscellaneous corporate characteristics *and either* centralization of title *or* limited liability."⁹⁴ However, no case was found holding the presence of all six of the miscellaneous corpo-

	<i>Present</i>	<i>Not Present</i>	<i>No Indication</i>	<i>Uncertain</i>
Board of Directors				
or Equivalent	55	15	6	8
Share Certificate	50	23	5	6
Trade Name	48	18	14	6

91. *Ibid.*

92. *Id.* at 191-92. He prepared the following table:

	<i>Present</i>	<i>Not Present</i>	<i>No Indication</i>	<i>Uncertain</i>
Managerial Succession	42	4	21	17
Formal Records	20	23	29	12
Formal Voting Procedure	18	20	23	13

93. *Id.* at 192.

94. *Ibid.*

rate characteristics group to be sufficient to create an association.⁹⁵

As Professor Sneed's study suggests, the courts have been concerned with examining various characteristics and on the basis of finding certain characteristics, or the lack of them, have made their characterizations accordingly. The criteria shift somewhat from case to case, with a court often merely mentioning and discussing some of the various "facts" and not always examining them in much depth. Professor Sneed's approach was to find the facts which occurred most frequently and to conclude that these facts would be consistent with, or perhaps require, classification as an association. He did not seek to find the critical facts for classification as a partnership.

Before considering significant, specific cases, a few more generalizations can be made. The courts normally cite the regulations and apply loosely whatever guidance the regulations give. Further, the courts seem to pay a lot of attention to the arrangement among the parties. Lastly, many of the cases deal with trusts engaging in business. The significance of trust cases will be discussed more fully below in connection with *Morrissey v. Commissioner*.⁹⁶ However, the trust was early recognized as a form for doing business and from the beginning the feeling was that these organizations should be taxed as associations. Most of the trust cases turn on whether or not the trust was engaged in business, and not so much on whether the criteria of an association call for a determination of taxation as an association; nevertheless, recitals of the criteria specified in the regulations appear. Generally, or perhaps universally, the analysis in the cases is most superficial.

A. THE MORRISSEY CASE

Morrissey is the leading Supreme Court case on the issue of what is an association. The petitioners were trustees of a trust which owned some land in the City of Los Angeles. The trustees set up the trust, which sold beneficial interests in the trust evidenced by certificates or shares. Exclusive management power was vested in the trustees who might call a meeting of shareholders to give a report, but any votes or recommendations of the shareholders were to be advisory only. The trust was to continue for 25 years, but was not to end upon the death of a beneficiary or trustee.⁹⁷ Under the trust terms, the trustees were said

95. *Ibid.*

96. 296 U.S. 344 (1935).

97. *Id.* at 347-48.

to have no power to bind the beneficiaries by "any act, neglect or default . . ." Any indemnity to a third person or even a beneficiary was to come from trust property only, according to the trust instrument.⁹⁸ The trust subdivided one-third of the land and sold it, mostly on installment sales. The trust also had some activities in operating a golf course on the land.

The Commissioner argued that all business trusts should be taxed as associations and that this was a business trust, distinguishing a trust which merely collects rent or engages in modest activity to liquidate trust property.⁹⁹ The taxpayer asserted two opposing arguments: First, that no association existed unless the beneficiary had some voice or control over the activities of the trust; and second, that the trust was not carrying on a business.¹⁰⁰ As to the second argument the Court concluded that the trust was carrying on a business.¹⁰¹

The taxpayer's first argument grew out of an early Supreme Court decision, *Crocker v. Malley*.¹⁰² That case involved the revenue act of 1913, which imposed a tax on the net income of "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships."¹⁰³ The Court took the position that the statute was not intended to include a trust when the beneficiaries were not partners and had "no joint action or interest and no control over the fund."¹⁰⁴ The Treasury Department thereupon assumed that classification of a trust as an "association" depended upon the degree of control given the beneficiaries over the trust management.¹⁰⁵

The Morrissey Court rejected this argument by the petitioner,¹⁰⁶ pointing to the Court's broader reading of the word "association" in *Hecht v. Malley*.¹⁰⁷ That case found that Congress extended the term from covering only organizations organ-

98. *Id.* at 347.

99. *Id.* at 349.

100. *Id.* at 348-49.

101. *Id.* at 361.

102. 249 U.S. 223 (1919).

103. Act of Oct. 3, 1913, ch. 16, § II. G(a), 38 Stat. 172 (1913); see text accompanying notes 51-56 *supra*.

104. 249 U.S. at 233-34.

105. Treas. Reg. 45, art. 1504 (1920 ed. 1921): "If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute."

106. 296 U.S. at 351-54.

107. 265 U.S. 144 (1924).

ized as associations under statutes "to include also organizations exercising the privilege of doing business as associations at the common law."¹⁰⁸ The earlier, more restrictive reading — businesses organized under state laws providing for associations — derived from the use of the words "organized under the laws of the United States," in the 1909 and 1916 acts.¹⁰⁹ The 1918 act omitted these words and the Court accordingly concluded that a broader definition of "association" should be found — one including common law associations as well as those founded in statute.¹¹⁰ The Court further relied upon broad dictionary definitions.¹¹¹ The issue of beneficiary control was raised, although not so clearly, in the *Hecht* case and was decided against the trustees.¹¹² Thereafter, the Treasury amended its regulation to eliminate beneficiary control as a distinction between a trust and an association.¹¹³

The Court in *Morrissey* said that the Treasury was entitled to some leeway in promulgating rules defining the content of the word association:

As the statute merely provided that the term "corporation" should include "associations," without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision.¹¹⁴

The Court held that the Treasury acted reasonably in changing its regulation in the wake of the decision in *Hecht v. Malley* to take account of the broadened concept of "association" adopted by the Supreme Court in that case.¹¹⁵ The Court did not define what "administrative exigencies" might also justify a change in regulations, however.

In analyzing the meaning of "association," the Court pointed out that "association" implies "associates," or a "common effort . . . for the conduct of a business enterprise."¹¹⁶ It found that while the ordinary trust to hold and conserve property, with some

108. *Id.* at 155.

109. *Id.* at 154-55.

110. *Ibid.*

111. *Id.* at 157; see note 67 *supra*.

112. 265 U.S. at 147-48, 158-61.

113. Treas. Reg. 65, arts. 1502, 1504 (1924).

114. 296 U.S. at 354-55.

115. *Id.* at 355.

116. *Id.* at 356-57.

incidental powers, lacks this characteristic of entering into a joint enterprise, the business trust has as its object the "conduct of a business and sharing its gains," thus satisfying the term association in a broad sense.¹¹⁷

The Court then proceeded to refine its concept of association somewhat, to develop criteria for this classification, and to apply them to the facts of the case. After repeating that the term association means both a business organized under a statute and one existing at common law,¹¹⁸ the Court enunciated a general test of resemblance: "The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts."¹¹⁹ Next the Court discussed the importance of corporate forms as conclusive evidence of corporateness: "While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive."¹²⁰ Thus, the use of the usual terms for and forms of a corporation may suggest or compel classification as an association; moreover, a trustee may function as a director, and the trust instrument may serve as bylaws.¹²¹

Next, in the paragraph of the decision most quoted and cited, the *Morrissey* Court turned to question, "what, then, are the salient features of a trust — when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains — which may be regarded as making it analogous to a corporate organization?"¹²²

1. Title

The corporation holds title to the property of the corporation and the title is not affected by changes in the owners of the corporation. Similarly, trustees provide the same advantage for the trust, at least during the term of its existence. Although trustees may change or die, a title-holding mechanism similar to that of the corporation is found in a provision for succession of trustees.¹²³

117. *Ibid.*

118. *Id.* at 357-58.

119. *Id.* at 357.

120. *Id.* at 358.

121. *Ibid.*

122. *Id.* at 359.

123. *Ibid.*

This characteristic was very prominent in Professor Sneed's frequency study of the cases.

2. *Centralized Management*

"Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation."¹²⁴ In the *Morrissey* situation, the "designation of trustees" to conduct the business of the trust provided a "similar scheme, with corresponding effectiveness."¹²⁵ Thus the use of trustees to handle the affairs of the trust business is similar to the formal corporate structure of shareholders, board of directors, and officers. The Court did not think it important that the trustees in this case, or any case, were named in the trust instrument, had power to select their own successors, and therefore were self-perpetuating; nor did power in the beneficiaries over selection and tenure of trustees prevent the similarity to the corporation. The Court found the trustee arrangement to be "analogous to that of corporate activities."¹²⁶

3. *Security From Interruption of the Enterprise*

The Court found that a corporation is also characteristically "secure from termination or interruption by the death of owners of beneficial interests."¹²⁷ The Court referred to partnerships as distinguishable in this respect, but found a trust similar to a corporation, since it need not be terminated or subjected to the problems of a partnership when a beneficial owner dies, or sells out to a third party.

4. *Transfer of Beneficial Interests Facilitated*

The Court stated that the corporate form of doing business "facilitates . . . the transfer of beneficial . . . interests without affecting the continuity of the enterprise," and also facilitates "the introduction of large numbers of participants."¹²⁸ The trust type of organization was found to have the same characteristic or advantage. Certainly, the large number of transferable certificates issued by the trustees in *Morrissey* supported that view.¹²⁹

124. *Ibid.*

125. *Ibid.*

126. *Ibid.*

127. *Ibid.*

128. *Ibid.*

129. *Id.* at 360-61.

5. *Limited Liability*

The Court found that a trust resembled a corporation because "the trust method also permits the limitation of the personal liability of participants to the property embarked in the undertaking."¹³⁰

The Court, applying the above principles, found similarity or resemblance to a corporation on all counts and, therefore, concluded that the trust arrangement was an association.¹³¹ The case does not seem very startling at this late date. Substantial resemblance is shown between a corporation and the *Morrissey* trust arrangement, both in operation and structure. In spite of shunning the corporation label, the arrangement properly could be characterized as an association.

A few observations might be in order, however. (1) The Court was faced with a situation in which the Commissioner *wanted* the organization to be classified as an association or corporation. Since the Court found similarity or resemblance on each point examined, it had no occasion to comment upon the relative weight of each point in its decision. (2) While the decision followed the regulations and gave what has been thought to be a broad charter to the Treasury with respect to regulations on this question, in fact the Court's opinion only recognized a regulation that was altered because of a change in the law through an interpretation of a statutory change. The Court also recognized that changes might be made for administrative exigencies, but did not provide an analysis of what it considered to be proper exigencies. (3) The Court put considerable stress upon the arrangement as established in the trust instrument, with certain local law consequences. For instance, the Court did not look to how the organization operated *in fact* on the question of centralized management, but referred only to the structural arrangement. All of these factors tend to limit the case somewhat from the rather broad generalizations found in the opinion.

Note also that the centralization of management criterion is somewhat limited by companion cases to *Morrissey*. *Swanson v. Commissioner*¹³² involved the tax characterization of a trust which owned and operated an apartment house. The beneficial interests were called "receipts," and were assignable. Two of the three trustees were the actual beneficiaries and consequently there was no centralization of management in fact, although the trust in-

130. *Id.* at 359.

131. *Id.* at 360.

132. 296 U.S. 362 (1935).

strument provided that the trustees were to have "complete management and control of the property."¹³³ The Court held the arrangement taxable as an association: "The limited number of actual beneficiaries did not alter the nature and purpose of the common undertaking."¹³⁴

Likewise, *Helvering v. Coleman-Gilbert Associates*¹³⁵ limited the *Morrissey* concept of centralized management. In *Coleman* three men and the wives of two of them owned real property — 20 apartment houses. They conveyed the properties to themselves in trust for a period of 15 years. The trustees were given full management powers and the beneficiaries (who apparently were also the persons who were trustees) were to have no power. Limited liability was asserted by the trust instrument.¹³⁶ The Court found an association based upon the *Morrissey* principle: "The small number of persons in the trust now before us does not present a difference in the legal aspect of their enterprise from the standpoint of the statutory classification."¹³⁷ The Court found centralization in the agreement; and the fact that the trustees did not meet, vote, or keep records, and continued operating exactly as before, was considered immaterial.¹³⁸

Apparently, therefore, the facts on the number and identity of beneficiaries had no relevance. At least the opinion in the *Coleman* case seems to go that far, and the holding of *Swanson* implies that the number of trustees and owners and the identity of each has no relevance to centralization of management.

The Supreme Court's reference in *Morrissey* to the trust or corporation form providing security from termination of the enterprise also needs some limitation. Obviously, the termination or continuity of the business enterprise in any meaningful sense in the business world is a state of fact which has almost nothing to do with the form of business adopted. Today, and probably at the time of the Court's decision, no reason exists why any business operated by a partnership, corporation, or trust would have its enterprise continuity interrupted by the death, withdrawal, etc. of a partner, shareholder, or beneficiary.

To be sure, the rights and duties of the parties to the arrangement differ somewhat depending upon whether the arrangement is a partnership, trust, or corporation. A shareholder, or his estate,

133. *Id.* at 363.

134. *Id.* at 365.

135. 296 U.S. 369 (1935).

136. *Id.* at 370-72.

137. *Id.* at 372.

138. *Id.* at 373.

is left to the uncertain remedy of a shareholder's derivative suit to determine his rights,¹³⁹ and this rarely could terminate the enterprise. The trust beneficiary has extensive remedies against the trustee,¹⁴⁰ and is thought to be entitled to a high standard of care by him.¹⁴¹ Probably these elements distinguish the trust and the corporation somewhat, but they are in the same category for this tax purpose. Similarly, the partner has certain powers of dissolution and a right to an accounting,¹⁴² but his death or withdrawal normally would not cause termination of the enterprise as such, if the articles of partnership provide for continuation.¹⁴³ Furthermore, the death or withdrawal of a partner causes no termination of the entity for tax purposes.¹⁴⁴ A technical dissolution under local law of the old partnership entity and the creation of a new partnership takes place on such an occasion.¹⁴⁵ But it is difficult to see much of an advantage in using the corporate form to avoid this, or that continuity is a characteristic of a corporation in any real, as opposed to merely formal, sense. It is especially difficult to see that the trust provides better continuity than the partnership except in the most technical, and seemingly irrelevant, sense. Clearly, however, the Supreme Court must have referred to the avoidance of "dissolution" under local law on the occasions of change in beneficial interests, in adopting and applying the continuity test.

Finally, the Court's adoption and application of the limited liability criterion needs some clarification. Limited liability obviously is a characteristic of most corporations;¹⁴⁶ but it is not apparent that trusts which are engaged in business can provide this protection generally for the beneficial owners. A trust en-

139. See, *e.g.*, BALLANTINE, CORPORATIONS §§ 143-57a (rev. ed. 1946); HENN, CORPORATIONS §§ 352-83 (1961); LATTIN, CORPORATIONS 346-93 (1959); STEVENS, PRIVATE CORPORATIONS §§ 167-74 (2d ed. 1949).

140. See 2 SCOTT, TRUSTS §§ 197-226.1 (2d ed. 1956, Supp. 1964).

141. *Id.* § 174.

142. See, *e.g.*, MINN. STAT. § 323.21 (1961); UNIFORM PARTNERSHIP ACT § 22.

143. See, *e.g.*, MINN. STAT. §§ 323.29, .40 (1961); UNIFORM PARTNERSHIP ACT §§ 30, 41-42.

144. INT. REV. CODE OF 1954, § 706(c)(1) provides:

Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

145. See, *e.g.*, MINN. STAT. § 323.30 (1961); UNIFORM PARTNERSHIP ACT § 31.

146. See, *e.g.*, MINN. STAT. § 300.27 (1961).

gaged in business will not provide limited liability for the beneficial owners when the owners control the selection or exercise of the duties of the trustee.¹⁴⁷ In that event, the clear agency relationship will carry liability through to the beneficiaries. This agency might be expressed in the trust arrangement, or implied from the operation of the trust and the actual relationship of the trust to the beneficial owners.¹⁴⁸ The liability of trusts and trustees differs in some other ways from that of a corporation and its officers. If either a trustee or a corporate officer commits a tort, he will be personally liable for damages, notwithstanding the tort is committed in the course of the business of the trust or corporation.¹⁴⁹ If a tort is committed which is not due to the personal act of the corporate officer, he will, of course, not be liable for the damages personally.¹⁵⁰ The trustee is not so lucky, however. He will be liable personally for a tort committed in the trust business even though he did not commit it.¹⁵¹ For this reason, one would not be surprised to find a provision in a trust instrument providing for reimbursement of the trustee by the beneficial owners. In contract matters, the trustee avoids personal liability only when the contract relieves him of personal liability; he is not treated the same as the corporate officer even when he makes it clear that he acts on behalf of the trust as trustee.¹⁵² Therefore, the limited liability provided by trusts differs somewhat from the limited liability provided by corporations.

In the *Morrissey* case the beneficial owners had no control over the selection, tenure, and actions of the trustee.¹⁵³ Perhaps, therefore, no agency relationship was established so that the beneficial owners may have had actual, not just asserted, limited liability.¹⁵⁴ In some states, however, it has been claimed that the beneficial owners of a business trust would be liable personally for trust obligations even though they have no control over the action of the trust. "The basis for imposing liability is that the use of the trust as a substitute for the corporate device is against

147. BOGERT, TRUSTS AND TRUSTEES § 294 (2d ed. 1964); 3 SCOTT, *op. cit. supra* note 140, § 274.1.

148. *Id.* § 274.

149. BALLANTINE, *op. cit. supra* note 139, § 112; BOGERT, *op. cit. supra* note 147, § 300; 3 SCOTT, *op. cit. supra* note 140, § 276.

150. BALLANTINE, *op. cit. supra* note 139, § 112.

151. 3 SCOTT, *op. cit. supra* note 140, § 264.

152. BOGERT, *op. cit. supra* note 147, § 300; 3 SCOTT, *op. cit. supra* note 140, § 262.

153. See 296 U.S. at 347, 358.

154. BOGERT, *op. cit. supra* note 147, § 296 and California cases collected at 588 n.66.

public policy, as tending to evade the policy of the law against limited liability without incorporation."¹⁵⁵

While the Court may have been justified in finding limited liability in the *Morrissey* case, in many or most business trust situations, limited liability would not obtain. Furthermore, any actual, as opposed to asserted, limited liability in the *Swanson* and *Coleman* cases, the companion cases to *Morrissey*, is questionable. In *Swanson* two of the three trustees were the beneficial owners (as well as the settlors)¹⁵⁶ and in *Coleman* apparently the five settlors were also trustees and beneficiaries.¹⁵⁷ It would not be hard to find agency implied on those facts, and if agency could be implied there probably would be no limited liability.

Limited liability, therefore, appears to be a slender reed supporting classification of business trusts generally as associations. Furthermore, the facts of *Swanson* and *Coleman* raise the question whether actual, rather than only asserted, limited liability mattered, in terms of the ultimate result.

B. THE PELTON CASE

The case of *Pelton v. Commissioner*¹⁵⁸ concerned the tax classification of a medical clinic in Illinois. In that case the Commissioner contended that the arrangement was an association, and the doctors resisted that contention. The business, or medical practice, was organized as a trust with the beneficial owners as trustees. A majority of the beneficial owners could alter the arrangement. The trust shares were to be transferable, but the income of each doctor was determined on the basis of earning capacity and not upon property contributed.¹⁵⁹

The court concluded that the arrangement was an association, under the *Morrissey* case and the regulations. The taxpayers had argued that they could not be an *association* under local law since the Illinois Supreme Court had held that a *corporation* could not practice medicine in Illinois, and therefore the clinic must be a trust or a partnership. The court did not comment on the logical gap in the taxpayers' argument, but only said that the organization could be an association under the internal revenue laws even though technically a partnership under local law.¹⁶⁰

155. 3 SCOTT, *op. cit. supra* note 140, § 274, at 2114.

156. See notes 132-34 *supra* and accompanying text.

157. See notes 135-38 *supra* and accompanying text.

158. 82 F.2d 473 (7th Cir. 1936).

159. *Id.* at 474-75.

160. *Id.* at 476.

The questions about centralization of management and limited liability can be raised again with respect to this case. However, the court found association status in spite of the small number of beneficial owners and what appears to be no more than an assertion of limited liability.¹⁶¹

C. THE KINTNER CASE

The now famous case of *United States v. Kintner*¹⁶² involved a medical group who executed what they called "articles of association" in 1948. Under the terms of the articles, the association was to continue until the death of the last of the survivors of the original eight member doctors. The association could be dissolved by a three-fourths vote of all senior members. Only physicians or surgeons licensed to practice in Montana were eligible for admission to membership, but the beneficial interests in the association were nonassignable. The death or retirement of a member was not to cause dissolution of the association.¹⁶³ An executive committee of five was to manage the major business of the association generally and to fix salaries. Officers chosen by the executive committee took care of minor details of management.¹⁶⁴ A doctor employed by the clinic was subject to certain requirements: his salary was fixed by the executive committee — with no relationship to the number of patients he had or the fees they paid; the association controlled the hours and place of his employment, and his vacations; the details of his professional performance, of course, were not controlled closely; the doctor was limited as to the fields of medicine in which he could work; and to some extent patients were selected for the doctor. The control of doctors by the association was the same, whether older or younger, whether members of the association or nonmember employees. The clinic had 38 employees, medical and nonmedical.¹⁶⁵

The district court did not discuss the issue of limited liability except to observe that on this point the clinic "more closely resembles a partnership than a corporation."¹⁶⁶ The opinion of the

161. Apparently the only beneficial owners were also the trustees. *Id.* at 474. The taxpayers argued to the Seventh Circuit that they had the liability of partners, but the trust indenture stated that the trustees were not to be liable in a personal capacity. *Id.* at 474-75.

162. 216 F.2d 418 (9th Cir. 1954), *affirming* 107 F. Supp. 976 (D. Mont. 1952).

163. *Id.* at 420.

164. *Ibid.*

165. *Id.* at 420-21.

166. 107 F. Supp. at 979.

court of appeals, affirming the district court's decision, includes the information that "*only the members were to be liable to third parties for professional misconduct.*"¹⁶⁷ What that means is not clear. A note in the *Harvard Law Review* states that the group agreed that no member would be liable for another's professional misconduct.¹⁶⁸ Perhaps the court meant to say that "only the member committing misconduct was to be liable for professional misconduct." Later in the opinion it is said:

Although the Articles of Association disclaim liability to others for the negligence or lack of skill of the doctors, the Association which contracts with the patients and receives his fees would be responsible direct [*sic*] to the patient, even assuming that under the law of joint tortfeasors the doctors also might be held liable. For, in the last analysis, the patient deals with doctor and clinic. The authorities recognize joint and several liability resulting from the concurrent practice of medicine, whether in association, partnership or otherwise. . . . It follows that the non-liability clause does not stand in the way of considering the association before us a corporation¹⁶⁹

The court certainly is confusing in this section. Apparently, limited liability was asserted, although not found, by the court.

Since the laws of Montana precluded the doctors from practicing medicine under the form of a corporation, the Commissioner argued that *Mobile Bar Pilots Ass'n v. Commissioner*, holding that no association would be recognized and service income would be taxed directly to the pilots, applied.¹⁷⁰ The court distinguished that case by pointing out that the clinic situation was not similar to the *Pilots* situation, since "it would be impossible for petitioner to engage in the business of piloting as an independent contractor."¹⁷¹

The Government's other contentions were met with quotations from Supreme Court cases or the regulations, including the following:

"The term 'association' is not used in the Internal Revenue Code in any narrow or technical sense. . . . It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. . . ."¹⁷²

". . . If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one

167. 216 F.2d at 420. (Court's italics.)

168. Note, 75 HARV. L. REV. 776, 778 (1962).

169. 216 F.2d at 424.

170. 97 F.2d 695 (5th Cir. 1938).

171. 216 F.2d at 423-24.

172. *Id.* at 423 (quoting from Treas. Reg. 111, § 29.3797-2 (1943)).

or more persons in their representative capacities, such an organization is an association, taxable as a corporation."¹⁷³

The *Kintner* case is significant for several reasons. The Uniform Partnership Act was part of Montana law at the time the case arose, and this arrangement probably constituted a partnership under local law.¹⁷⁴ The court thought local law should not control, however, and sought to apply the federal definition of association found in the regulations. Thus, although the clinic may have been a partnership for most or all purposes under local law, the parties had given the arrangement such characteristics *by agreement* to classify it as an association for federal tax law purposes.

This case also marks the point where the taxpayer successfully turned against the Commissioner the earlier cases seeking to classify doubtful cases as associations, and the regulations pointing in the same direction. The taxpayer won, in other words, a battle which the Commissioner normally pressed; the revenue and consideration had switched, and so had the arguments of the parties.

The case has great significance on most of the criteria mentioned by the Court in the *Morrissey* case. First, there was centralization of management; but not necessarily any more than a partnership might have achieved in fact, or perhaps no more than it might achieve by agreement. The court was persuaded by the *arrangement* which subjected *all* to control by the group. Second, the probable lack of the asserted limited liability also seems significant. The court's opinion is not clear on this issue, or even on what it meant by limited liability. But it concluded that whatever liability or nonliability there was did not prevent classification as an association. In other words, perhaps the court found an association even if liability were unlimited. Third, the continuity of life provisions were unusual, since the term was limited to the last survivor of the original group of eight member doctors, but this was sufficient continuity of life to satisfy the court.

173. *Ibid.* (quoting from Treas. Reg. 111, § 29.3797-4 (1943)).

174. *Id.* at 425-26: "The taxpayer concedes that the association is probably a partnership under Montana state law." See also Smith, *The Kintner Problem*, in Proceedings, Third Annual Montana Tax School 39-40 (Mimeo. 1955): "The former partners (who still remain partners under State law) are employees of the Association and as such may qualify for pension trust benefits. . . . The burdens of corporate form are all present and at the same time many of the disadvantages of the partnership form (since the organization is of necessity a partnership under State law) are likewise present." Mr. Smith represented the taxpayers in the *Kintner* case.

This case was hailed as a great victory for the taxpayers. The response of the Commissioner to this decision was to amend his regulations with the so-called "Kintner Regulations," under which probably even the Kintner group would not be classified as an association. These regulations will be discussed in the next section of this article.

D. THE GALT CASE

*Galt v. United States*¹⁷⁵ was a victory by some Texas doctors who had adopted the form of an association for their medical practice. The facts are similar to *Kintner* — the association had a board of directors and an executive committee. The executive committee played a substantial role in many decisions — salary, fiscal affairs, hours of work, vacations, travel, complaints, conflicts between doctors, and hiring of doctors. The clinic was departmentalized and each doctor was limited to practice in his department. Patients were assigned to doctors and the doctor could not refuse a patient assigned. The court said, "The associates also accept full control over their activity and professional work by the Association, except only for the privilege of confidential communications with a patient."¹⁷⁶ The court did not explain what control over professional work was exercised by the association. Ownership in the association could be transferred, but the association and the associates would have a first option to buy at the offering price.¹⁷⁷

The court concluded that the association provided centralization of title, centralization of management, continuity of the organization, transferability of membership, and limited liability;¹⁷⁸ and therefore it met all the tests of an association under the regulations. To the court, the simple controlling proposition was "that an association couched in language similar to the language of a charter of a corporation should be treated for tax purposes in the same manner that the corporation is treated."¹⁷⁹ How this association provided limited liability is difficult to see, although it clearly adopted the other forms of a corporation short of a charter. Part of the findings of fact was that "under the Articles, the associates do not become liable for the indebtedness of the Association or

175. 175 F. Supp. 360 (N.D. Tex. 1959). A complete version of the findings of fact appears in 59-2 U.S. Tax Cas. 73513. The Government's appeal was dismissed on stipulation of the parties. 257 F.2d 811 (8th Cir. 1958).

176. 59-2 U.S. Tax Cas. at 73516.

177. *Id.* at 73515.

178. *Id.* at 73516-17.

179. 175 F. Supp. at 362.

of any other associate until the assets of the Association and of the defaulting associate have been used in full to reduce the indebtedness."¹⁸⁰ That arrangement does not even *assert* limited liability, and nothing more is stated about limited liability except for the conclusion that this association had it. One must therefore assume that this is an organization without limited liability yet classified as an association for tax purposes.

E. THE FOREMAN CASE

*Foreman v. United States*¹⁸¹ is another medical clinic case. Two Florida orthopedists formed an association in 1960 using articles similar to typical articles of incorporation. The association was to continue in perpetuity. The business of the association was to be managed by a board of governors who determined the salaries, hours, working conditions, and vacations of the doctors. Ownership interests in the association were transferable, but the association and other associates had a first option. The articles provided that death, resignation, insolvency, bankruptcy, removal, or retirement of an associate should not cause dissolution.¹⁸² Later that year an agreement was signed with a third doctor providing five years employment and transfer of ownership interests gradually to him.¹⁸³

The court found that the facts of the case met the criteria of centralized management, continuity of life, and transferability of interests more strongly than the facts in *Kintner* or *Galt*.¹⁸⁴ It is difficult to see how there could have been more centralized management than in *Kintner*. In the *Foreman* case there was no centralized management in fact; only the formal structure could provide it in any sense. Obviously, the court was referring to the structure providing centralized management, rather than actual centralized management. However, why this structure provided more centralized management than the *Kintner* structure is unclear. The clinic in the *Foreman* case probably had more continuity of life in the formal sense; the life in *Kintner* was limited to the life of the survivor of the original eight members, whereas in *Foreman* it was perpetual. In addition, since interests were not transferable in *Kintner*, *Foreman* obviously had more formal transferability through the first option arrangement.

The court observed that there was no limited liability in

180. 59-2 U.S. Tax Cas. at 73516.

181. 232 F. Supp. 134 (S.D. Fla. 1964).

182. *Id.* at 134 n.1.

183. *Id.* at 135.

184. *Id.* at 136.

Kintner, Galt, or Foreman.¹⁸⁵ The court rejected, on grounds of uniformity from state to state, the Government's argument that this association could not resemble a corporation since doctors could not legally form a corporation in Florida.¹⁸⁶ The court also rejected the Government's argument that *Mobile Bar Pilots Ass'n v. Commissioner*¹⁸⁷ was controlling.¹⁸⁸ The Government made, according to the court, an argument contending that the association did "not earn the kind of income normally earned by a corporation," since its income came from personal services primarily. The court replied:

The fallacy of this argument is readily apparent when one considers the large number of corporations presently existing in our economy whose primary income is earned solely from the personal services of their employees. The corporate tax status of businesses engaged in advertising or promotion, investigation, sales, contract janitorial or secretarial service, to name a few, has not been seriously questioned to the Court's knowledge.¹⁸⁹

On a factual basis, it is hard to find centralization of management, continuity of life, and transferability of interests on the facts of the *Foreman* case; the only basis for saying that these characteristics are present is to rely upon the formal, legal structure adopted by the group. That structure apparently provides those characteristics, no matter how doubtful it may be that the group actually has such characteristics.

F. THE CASES APPLIED TO THE MODELS OR HYPOTHETICAL SITUATIONS

1. *Professional Association*

Referring to the various factors subjected to the frequency analysis by Professor Sneed, the "universal" facts present in all the cases holding the organization taxable as an association are present in the model professional association too: (a) two or more persons pursue a common object; (b) the objective is to carry on a business for profit; (c) the death of associates does not terminate the enterprise (in this respect the Georgia professional association certainly is stronger than the *Kintner* association);¹⁹⁰ (d) the transfer of an interest in the organization does not ter-

185. *Ibid.*

186. *Ibid.*

187. 97 F.2d 695 (5th Cir. 1938).

188. 232 F. Supp. at 136-37.

189. *Id.* at 137.

190. See text accompanying notes 83, 162 & 163 *supra*, and note 174 *supra* and accompanying text.

minate it; and (e) someone acts as common agent of those associated in the venture.¹⁹¹ Furthermore, the nonuniversal facts are present: (a) some sort of entity apart from the members; (b) clearly centralized legal title; (c) a body analogous to a board of directors; (d) authority to issue shares; (e) a trade name; and also, apparently, (f) limited liability.¹⁹² How much limited liability is questionable; but liability is clearly limited in contract matters, and probably substantially limited in matters of professional conduct.¹⁹³ Managerial succession, formal records, and formal voting procedures could also be present.¹⁹⁴

Some questions have been raised about the presence of centralized management in the case of a professional association.¹⁹⁵ If the cases are any guide, these associations clearly have centralized management. Only in the *Galt* case is there even a recital of control over professional decisions.¹⁹⁶ Certainly, more centralized management is present in fact with a larger medical group than in the *Swanson*,¹⁹⁷ *Coleman*,¹⁹⁸ and *Foreman*¹⁹⁹ cases. Furthermore, all the cases seem to say that centralization in fact is not even considered, but only the structure which provides for a board of directors making certain decisions.²⁰⁰ That the board of directors is composed of a number which is *not* less than the number of owners did not seem to matter at all in *Swanson*, *Coleman* and *Foreman*.

The existence of continuity of business for such groups has also been questioned, since they are subject to proceedings for dissolution.²⁰¹ One answer is that all corporations are thus subject, more or less.²⁰² No indication is given in any of the cases

191. See Sneed, *More About Associations in the Oil and Gas Industry*, 33 TEXAS L. REV. 168, 187-89 (1954); text accompanying notes 81-84 *supra*.

192. See Sneed, *supra* note 191, at 189-91; text accompanying notes 87-91 *supra*.

193. See notes 395-403 *infra* and accompanying text.

194. Note 92 *supra* and accompanying text.

195. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1, 8-13 (1961).

196. Note 176 *supra* and accompanying text.

197. 296 U.S. at 363; see text accompanying notes 132-34 *supra* (two of three trustees were the beneficial owners).

198. 296 U.S. at 370-72; see text accompanying notes 135-37 *supra* (the three men and their wives were the trustees and beneficial owners).

199. 232 F. Supp. at 134-35; see text accompanying notes 181-83 *supra* (three doctors, three owners).

200. In each case the court talked about the structure and seemed unconcerned about the actual facts of centralized management.

201. Bittker, *supra* note 195, at 15-17.

202. See notes 372-73 *infra* and accompanying text.

that it matters whether this subjection is more or less. Another answer is that the early legislative history and cases talk rather about avoiding discontinuity in the event of death or resignation of a member.²⁰³ Clearly, the structure of the Georgia professional association provides that.²⁰⁴ Furthermore, Sneed's analysis does not even rest upon strict entity continuity, but rather upon enterprise continuity.²⁰⁵ That sort of continuity can be achieved even by a partnership, and clearly these associations have continuity to a much greater extent.²⁰⁶

These associations can have only doctors as beneficial owners, and the association may place certain restrictions upon the transfer of shares. These factors have been cited as reasons suggesting a lack of the required transferability of interest.²⁰⁷ An association was found in the *Kintner* case even though the shares could not be assigned.²⁰⁸ Sneed's analysis does not mention restrictions on share transfers; he refers to the authority to issue shares, and certainly that is present in the professional association.²⁰⁹ Also, whether restricted or not (note that the shares in *Foreman* were "transferable" even though subject to a first option),²¹⁰ the general structure of these associations would make transferability of beneficial interest easier than for interests in the typical partnership. Under this heading *Morrissey* talks about the arrangement *facilitating* "the transfer of beneficial interests without affecting the continuity of the enterprises, and also [facilitating] the introduction of large numbers of participants."²¹¹ That the association facilitates transfers without discontinuity resulting can hardly be questioned; the possibility of having a large number of participants introduced also seems evident. A look at *Swanson*, *Coleman*, and *Foreman* should also serve to convince one that the actual number of participants does not seem to be a factor weighed heavily, if at all.

The limited liability characteristic of these professional associations has been questioned as a result of the vague wording of part

203. See notes 46 & 127 *supra* and accompanying text.

204. See note 14 *supra* and accompanying text.

205. See notes 83 & 85 *supra* and accompanying text.

206. For example, compare the continuity of the professional association which may be perpetual, with that of the *Kintner* group. The group was, by the terms of the articles, to exist only until the death of the survivor of the original members. 216 F.2d at 420.

207. Bittker, *supra* note 195, at 17-21.

208. Note 163 *supra* and accompanying text.

209. Note 90 *supra* and accompanying text.

210. 232 F. Supp. at 134 n.1; see text accompanying note 182 *supra*.

211. 296 U.S. at 359; see text accompanying note 128 *supra*.

of the enabling statute.²¹² Most probably, however, they have substantial limited liability, much greater than that of a partnership in any event. Furthermore, if there is any dilution of limited liability, it is not great.²¹³ Consequently, this factor seems to be present.

These associations, therefore, appear to have the characteristics discussed in *Morrissey* and the other cases to a high degree. As much centralization of management and continuity of business is found as in any of the cases discussed herein; certainly there are shares and they may be transferred more easily than the *Kintner* shares, and one might suspect, the *Swanson* and *Coleman* shares, too. Finally, there appears to be more limited liability than in *Swanson*, *Pelton*, *Galt*, *Kintner*, or *Foreman*. Applying Sneed's frequency analysis, the presence of centralization of legal title *plus* the miscellaneous corporate characteristics (board of directors, etc.) is sufficient to find association status. Further, limited liability *plus* the miscellaneous corporate characteristics would be sufficient. Therefore, applying these tests, the professional association clearly is an association.

2. Professional Corporation

The case for an association here is even stronger. Much less question, if any, is raised about the characteristic of limited liability. The Minnesota statute originally had the same ambiguity as the Georgia statute. As originally enacted in 1961, it read:

Sec. 16. [319.16] Relationship to person served. This act does not alter any law applicable to the relationship between a person furnishing professional service and a person receiving such professional service, including liability arising out of such professional service.²¹⁴

The provision probably meant nothing more than that the confidential relationship is preserved, and, as ought to be obvious, that a corporate employee remains personally liable for his own torts.

The section as amended in 1963, however, reads as follows:

Sections 319.01 to 319.23 do not alter any law applicable to the relationship between a person furnishing professional service and a person receiving such professional service, including liability arising out of such professional service; provided, however, that nothing contained in this section shall render a person personally liable in tort for any act in which he has not personally participated; and provided further, that nothing contained in this section shall render a director, officer, or

212. Bittker, *supra* note 195, at 8-13.

213. See notes 395-403 *infra* and accompanying text.

214. Minn. Sess. Laws Extra Sess. 1961, ch. 1, § 16.

employee of a professional corporation personally liable in contract for any contract which he executes on behalf of a professional corporation within the limits of his actual authority.²¹⁵

This amendment also has some ambiguities. It is not clear whether participating in treatment is enough to involve a doctor in personal liability for his fellow employee's professional negligence,²¹⁶ or whether either responsibility for the negligence (as respects the liability of a surgeon) or actual negligence on the part of the participant must be found. Presumably, either actual negligence or the imputed negligence under the captain-of-the-ship theory is required.²¹⁷ Whatever it means, the section does grant substantial limited liability.

The professional corporation has the further advantage of bearing the label "corporation." No case can be found where a "corporation" is classified as other than a corporation for tax purposes, barring the sham transaction cases.²¹⁸ Perhaps it is sufficient that a business bear the name corporation, under a corporation statute, and bear at least some remote resemblance to a corporation (whatever that is). The ordinary partnership with the label corporation would not qualify, but perhaps everything else will. The lack of cases discussing the point lends some support to this analysis.

3. *Colorado Professional Corporation*

No confusing language governs the limited liability of this group. This corporation is formed as any other corporation. The rules of civil procedure impose some conditions to ethical use of the corporate form for practicing law,²¹⁹ but those conditions should not bear on the classification for tax purposes. This organization appears to have a strong case for classification as a corporation for tax purposes.

4. *Personal Service Corporation and Manufacturing Corporation*

Nothing in these cases suggests any question about the tax classification of either organization. The only problem case is *Mobile Bar Pilots Ass'n v. Commissioner*,²²⁰ which involved an

215. MINN. STAT. ANN. § 319.16 (Supp. 1964).

216. This is referred to as a middle, but strained interpretation of the original language of a similar statute. Note, 75 HARV. L. REV. 776, 781 (1962).

217. *Ibid.*

218. See note 79 *supra* and accompanying text.

219. COLO. R. CIV. P. 265.

220. 97 F.2d 695 (5th Cir. 1938).

attempt to change employees of various employers into an association of persons, apart from the status of employees of various employers, for tax purposes. The case was adequately distinguished in *Kintner*²²¹ and *Foreman*.²²²

In conclusion, therefore, the cases support and even appear to require classification of all five models as associations or corporations for federal income tax purposes. The opinions in these cases, however, are addressed to ad hoc situations and do not attempt to delineate controlling criteria. *Morrissey* should be read accordingly. Most of the cases find all the characteristics of corporations present, even though one or more may in fact appear to be missing. Consequently, no occasion is presented in these opinions for a relative weighing of the various factors with reference to their importance. All the opinions suffer from the lack of a discussion of the relevance of each so-called characteristic or criterion of corporations. The idea of resemblance is mentioned, but no justification beyond that rather general basis for making the classification is given. In the cases examined, a striking emphasis is placed upon the agreement of the parties, with less emphasis given to local law specifications independent of the relationship of the parties.

III. THE ADMINISTRATIVE INTERPRETATION — THE REGULATIONS

A. SCOPE OF THE POWER TO ISSUE REGULATIONS

Regulations are the most authoritative of the various forms of interpretations issued by the Treasury Department.²²³ Adopting the useful classification of regulations as either "interpretative" or "legislative,"²²⁴ clearly the regulations issued under section 7701 are not legislative rules, precluding a reviewing court from substituting its judgment for the Treasury's; rather, these regulations are interpretative rules.²²⁵ Section 7805, providing that "the Secretary or his delegate shall prescribe all needful

221. 216 F.2d at 423-24; see text accompanying note 171 *supra*.

222. See notes 188-89 *supra* and accompanying text.

223. Each issue of the *Internal Revenue Bulletin* contains, on page two, the following passage: "Revenue Rulings and Revenue Procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations. . . ."

224. 1 DAVIS, ADMINISTRATIVE LAW TREATISE § 5.03 (1958) [hereinafter cited as DAVIS].

225. Surrey, *The Scope and Effect of Treasury Regulations Under the Income, Estate and Gift Taxes*, 88 U. PA. L. REV. 556, 557-58 (1940).

rules and regulations for the enforcement of this title . . . ,”²²⁶ does not seem to grant legislative power to the Treasury, but only refers to the usual power of an administrative agency to issue interpretations of the law it enforces.²²⁷

However, even interpretative rules may have the force of law to the extent that a court will defer to the interpretation by the administrative body and will refrain from exercising its own judgment on the subject matter covered by the regulations. Under certain circumstances the Treasury Regulations are usually accorded great authoritative weight: “(1) When the regulation embodies a construction made contemporaneously with the enactment of the statute, (2) when the regulation is of long standing, and (3) when the statute has been reenacted with the regulation outstanding.”²²⁸

Absent one or more of those special circumstances, courts seem to exercise their own judgments as freely as necessary in the particular case.²²⁹ Of course, when a court agrees with the judgment expressed in a regulation, it need only cite the regulation, perhaps with a reference of deference paid to the Treasury’s judgment on the matter. Thus result such statements as:

As the statute merely provided that the term “corporation” should include “associations”, without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction.²³⁰

Or even stronger:

This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons.²³¹

When a court does not agree with the judgment expressed in the regulation, it need only point out that the regulations are administrative interpretations, and not binding in any way upon the court. Accordingly: “We think the regulations are in the teeth of the unambiguous mandate of the statute, are contradictory of its plain terms, and amount to an attempt to legislate.”²³² The

²²⁶ INT. REV. CODE OF 1954, § 7805(a).

²²⁷ 1 DAVIS § 5.03, at 300, § 5.04, at 310-11; Surrey, *supra* note 225, at 558.

²²⁸ 1 DAVIS § 5.05, at 317.

²²⁹ *Ibid.*

²³⁰ Morrissey v. Commissioner, 296 U.S. 344, 354-55 (1935).

²³¹ Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948).

²³² Helvering v. Sabine Transp. Co., 318 U.S. 306, 311-12 (1943).

above rather strong characterizations of the clarity of the statute must be tempered by the knowledge that the Board of Tax Appeals and three of the eight Justices participating came to the opposite conclusion.²³³

Professor Surrey once stated:

Such Regulations constitute the Department's interpretations of the Revenue Act and serve to guide the personnel of the Bureau and the taxpaying public in the application of the law. In view of the necessary brevity of the statutory law and the manifold fact situations to which it applies, these guides are of some assistance to taxpayers. But they still remain no more than the Department's construction of the Revenue Act. Apart from their binding effect upon the personnel of the Bureau of Internal Revenue, they do not as Regulations possess any authority.²³⁴

Proposals to give the Treasury Department more of a role in legislating through regulations, however desirable if the regulation were uniformly fair minded, face the following objection:

The main difficulty lies . . . in the Treasury's inability, by reason of its special function as tax-gatherer and protector of the revenues, to hold an even balance between the interests of the taxpayers and its own interests as the government's agency for getting money. The Treasury is inevitably biased in favor of the government, and this is frequently illustrated by the way in which the tax regulations reach far to the edge of each twilight zone and often beyond.²³⁵

As mentioned above, courts are inclined to give great weight to rules either published shortly after enactment of the statute ("contemporaneous") or long-standing, or both. An opinion of the Supreme Court in 1956 furnishes one example of such reliance: "There are persuasive reasons for construing 'debentures' and 'certificates of indebtedness' in accordance with the Treasury's original interpretation of those terms in this statute's altogether comparable predecessors."²³⁶ The Court then quoted with approval the following language from an earlier Cardozo opinion: "[A]dministrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful."²³⁷ The Supreme Court then went on to say:

233. 1 DAVIS § 5.05, at 319.

234. Surrey, *supra* note 225, at 557.

235. Miller, *Responsibilities Which Should Be Met by Congress*, in TAX INSTITUTE, INCOME TAX ADMINISTRATION 21, 28-29 (1948).

236. United States v. Leslie Salt Co., 350 U.S. 383, 396 (1956).

237. *Ibid.* (quoting Norwegian Nitrogen Prod. Co. v. United States, 288 U.S. 294, 315 (1933)).

Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand. Moreover, that original interpretation has had both express and implied congressional acquiescence, through the 1918 amendment to the statute . . . , which has ever since continued in effect, and through Congress having let the administrative interpretation remain undisturbed for so many years.²³⁸

The courts usually give considerable weight to regulations that have "long standing."²³⁹ Sometimes this factor operates in combination with the "reenactment" rule.²⁴⁰ The courts also give weight to regulations issued shortly after enactment of a section, under the label of "contemporaneous" regulations.²⁴¹

The Supreme Court has used some rather strong language concerning a long-standing rule: Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.²⁴²

Under these circumstances we think that the Regulations have acquired the force of law. . . . Here we have unambiguous regulatory language, adopted by the Commissioner in the early days of federal income tax legislation, in continuous existence since that time, and consistently construed and applied by the courts on many occasions . . .²⁴³

However, in some cases the Supreme Court has not followed long-standing regulations,²⁴⁴ and consequently one must conclude that although such regulations will be given great weight, they may be set aside where the Supreme Court finds reason on the merits to do so. The Supreme Court has also referred approvingly to the doubtful reenactment rule.²⁴⁵ These rules, therefore, often are entitled to substantial weight, but do not compel one result or another. Also, cross currents develop, and one rule of interpretation may indicate one result while another rule may suggest the opposite result.

One of the most relevant points on the problem under consideration in this article is the effect of a change in regulations after the regulations acquire the status "long standing" and after they

238. 350 U.S. at 396-97.

239. 1 DAVIS § 5.06.

240. *Id.* § 5.06, at 325.

241. *Ibid.*

242. *Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

243. *Cammarano v. United States*, 358 U.S. 498, 510-11 (1959).

244. 1 DAVIS § 5.06, at 328.

245. See 1 DAVIS § 5.07, at 331. The rule has been extensively criticized. *E.g.*, Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398 (1941); Surrey, *supra* note 225, at 559-61.

have survived many "reenactments." Several Supreme Court decisions touch on aspects of this problem. In *Helvering v. R. J. Reynolds Tobacco Co.*,²⁴⁶ the Supreme Court held that the Treasury could not retroactively apply an amendment to long-standing and uniform administrative practice. The Court did not decide, however, whether the rule could be changed prospectively.²⁴⁷ Later in 1939 the Court did hold that a regulation could be amended and applied prospectively,²⁴⁸ but the case is of doubtful value since the Court apparently assumed that the Treasury was amending a legislative regulation.

In *Helvering v. Reynolds*²⁴⁹ the Court upheld a change of regulations. However, the language of the law itself was changed and then changed back in 1934 to the original language.²⁵⁰ The change in regulations came in 1935.²⁵¹ The Court treated the 1934 act as a new one and therefore the regulations could be treated as a contemporaneous interpretation of a new act, rather than as a change of a long-standing administrative interpretation with no relevant change in the statutory language.²⁵² The case, consequently, is not conclusive on this issue.

In *Massey Motors, Inc. v. United States*²⁵³ the Supreme Court did allow a retroactive application of certain regulations on depreciation. In the eyes of the majority, the regulation was a clarification of uncertain law.²⁵⁴ The dissenters, however, found a consistent administrative practice which was changed by these regulations, and thus found the retroactive change in the Commissioner's position objectionable.²⁵⁵ The dissenters admitted that the Code and earlier regulations themselves were inconclusive, but found the consistent administrative practice in the litigating positions the Commissioner had taken over a long period of time.²⁵⁶ The case certainly does not involve a change in long-

246. 306 U.S. 110 (1939).

247. *Id.* at 116.

248. *Helvering v. Wilshire Oil Co.*, 308 U.S. 90.

249. 313 U.S. 428 (1941).

250. *Id.* at 435-36 (dissenting opinion).

251. *Id.* at 440 (dissenting opinion).

252. *Id.* at 443:

No relevant regulation was in force at the time respondent sold the securities in 1934. The regulation here in question was promulgated under the very Act which determines respondent's liability. The fact that the regulation was not promulgated until after the transaction in question had been consummated is immaterial.

253. 364 U.S. 92 (1960).

254. *Id.* at 100-04.

255. *Id.* at 108-19.

256. *Ibid.*

standing regulations, however, and has little value as an authority on that question.

Accordingly, long-standing regulations probably will be given great weight by the Supreme Court and other federal courts, particularly where they have been approved consistently over the years by the courts, including the Supreme Court. The case for administrative change of long-standing regulations, consistently followed by the courts, is quite doubtful, for no Supreme Court case seems to so hold squarely. Normally, a change in directions in amendments to such regulations would seem to have little chance for judicial approval, if the Supreme Court's opinions and holdings are any basis for prediction.

B. THE EARLY REGULATIONS

The regulations issued under the 1894 act²⁵⁷ merely refer to "corporations, companies, and associations, both resident and foreign, doing business for profit in the United States,"²⁵⁸ in almost exactly the words of the statute. As in the statute, the regulations specified that "partnerships, as such, are not liable to taxation of firm or partnership profits or income, but each individual member of the partnership shall include . . ."²⁵⁹ his share of the profits in his income. No definition of associations was provided under the law or the regulations.

The first definition of associations appeared in Regulations 33,²⁶⁰ issued under the revenue act of 1913. This rather compre-

257. Regulations and Law Relative to Income Tax (1894) [hereinafter cited as *Treas. Reg. 1894*].

258. *Treas. Reg. 1894*, at 24.

259. *Treas. Reg. 1894*, at 25.

260. Regulations No. 33, Law and Regulations Relative to the Tax on Income of Individuals, Corporations, Joint Stock Companies, Associations, and Insurance Companies Imposed by Section 2, Act of October 3, 1913 (1914) [hereinafter cited as *Treas. Reg. 33 (1914)*]:

Art. 78. "Corporation" or "corporations," as used in these regulations, shall be construed to include all corporations, joint-stock companies or associations, and all insurance companies coming within the terms of the law, and such organizations will hereinafter be referred to as "corporations."

Art. 79. It is immaterial how such corporations are created or organized. The terms "joint-stock companies" or "associations" shall include associates, real estate trusts, or by whatever name known, which carry on or do business in an organized capacity, whether organized under and pursuant to State laws, trust agreements, declarations of trusts, or otherwise, the net income of which, if any, is distributed, or distributable, among the members of share owners on the basis of the capital stock which each holds, or, where there is no capital

hensive though vague "definition" did not really define the term, but did indicate the wide intended scope of the words "corporations, joint-stock companies, or associations" by specifically including real estate trusts. The words of the regulation would support classification of partnerships as corporations, however. In fact, limited partnerships were characterized under these regulations as corporations.²⁶¹ Partnerships, however, were excluded in the statute, and the regulations so stated.²⁶²

While the regulations of necessity excluded partnerships, they included limited partnerships in the concept of corporation.²⁶³ Apparently the limited liability and general resemblance, whatever that was, of these organizations to corporations led the drafters of the above-quoted regulation to characterize the limited partnership as a corporation.

Slight changes in Regulations 33 were made under the Revenue Acts of 1916 and 1917 by including as corporations business trusts issuing shares,²⁶⁴ and by substituting the term "common-law trusts" for "real estate trusts" in the provision defining joint-stock companies and associations.²⁶⁵ No doubt this latter change

stock, on the basis of the proportionate share of capital which each has invested in the business or property of the organization, all of which joint-stock companies or associations shall, in their organized capacity, be subject to the tax imposed by this act.

261. *Treas. Reg. 33, art. 86 (1914)*: "Limited partnerships are held to be corporations within the meaning of this act and these regulations, and in their organized capacity are subject to the income tax as corporations."

262. *Treas. Reg. 33, art. 94 (1914)*: "Ordinary copartnerships are not, as such, subject to the tax imposed by this act . . ."

263. *Regulations No. 33 (Revised) Governing the Collection of the Income Tax Imposed by the Act of September 8, 1916, as Amended by the Act of October 3, 1917, art. 62 (1918)* [hereinafter cited as *Treas. Reg. 33 (rev. 1918)*].

264. *Treas. Reg. 33, art. 57 (rev. 1918)*:

. . . Corporation defined.—"Corporation" or "corporations," as used in these regulations, shall be construed to include all corporations, joint-stock companies and associations, and all insurance companies coming within the terms of the law, as well as all business trusts organized or created for the purpose of engaging in commercial or industrial enterprises, the capital of which is evidenced by certificates or shares of interest issued or issuable to members on the basis of which profits are distributed or distributable. Such organizations will be hereinafter referred to as corporations.

This section corresponds to *Treas. Reg. 33, art. 78 (1914)*, promulgated under the 1913 act.

265. *Treas. Reg. 33, art. 58 (rev. 1918)*: "Joint-stock companies and associations defined.—The term 'joint-stock companies' or 'associations' shall include associations, common-law trusts, or organizations by whatever name known

is merely the use of a more general term in place of a more specific term. Limited partnerships still were taxed as corporations with, apparently, limited liability still the controlling characteristic.²⁶⁶ The "common-law partnership," in which all owners had liability for debts of the business, was distinguished, and not taxed as an association or corporation.²⁶⁷

The regulations promulgated under the Revenue Act of 1918 are called Regulations 45.²⁶⁸ The definition of association, article 1502, is virtually the same as in Regulations 33.²⁶⁹ However, new provisions appeared distinguishing associations from partnerships and from trusts.²⁷⁰

which carry on or do business in an organized capacity . . ." Article 58 closely resembles Treas. Reg. 33, art. 79 (1914), promulgated under the 1913 act.

266. Treas. Reg. 33, art. 62 (rev. 1918):

. . . Limited partnerships.—Limited partnerships—that is, partnerships having one or more special partners who may share in the profits of the firm but whose liability for the debts of the company is limited to the amount of capital invested by such special partner or partners—are held to be associations within the meaning of the title, and as such are required to make returns of annual net income and pay any tax thereby shown to be due. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as if it were dividends on the stock of corporations and will be subject to the additional or surtaxes in the hands of the recipient.

This section adds little substance although varying the words of Treas. Reg. 33, art. 56 (1914).

267. Treas. Reg. 33, art. 63 (rev. 1918).

268. Regulations 45 Relating to the Income Tax and War Profits and Excess Profits Tax Under the Revenue Act of 1918 (1920 ed. 1921) [hereinafter cited as Treas. Reg. 45 (1920 ed. 1921)]. Under this act two editions of regulations were promulgated, the first edition in 1920 and the 1920 edition in 1921.

269. See note 265 *supra*.

270.

ART. 1503. Association distinguished from partnership.—An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members cannot be so transferred is a partnership.

ART. 1504. Association distinguished from trust.—Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses

These regulations represent the first attempt to specify criteria for classifying organizations as associations, other than by reference to labels. The trust section was designed to distinguish a trust actively conducting a business from one used as an investment entity only. It was designed to reflect the Supreme Court's decision in *Crocker v. Malley*,²⁷¹ which held that a trust must carry on a business, and not merely hold property, for classification as an association. The Court also held that the beneficiaries must have some control over the manner in which the trust business is conducted.²⁷² The provision distinguishing associations from partnerships specifies two criteria for association status: first, the membership interests are transferable without consent of all the members, and second, the business of the organization is conducted by a board of directors, or its equivalent, without active participation by all of the members. Apparently an organization must meet both criteria stated to have association status.

Regulations 45 also contain some development of the classification of limited partnerships, emphasizing limited liability, avoidance of dissolution at death of or upon a transfer of interest by a member, centralization of title, and the ability to sue in the name of the organization.²⁷³ When an organization had all

to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the cestuis que trust are liable to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have the right to hold the income for future distribution, the net income is taxed to the trustees instead of to the beneficiaries. . . . If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute.

Treas. Reg. 45 (1920 ed. 1921).

271. 249 U.S. 223 (1919).

272. *Id.* at 233-34; notes 102-05 *supra* and accompanying text.

273.

ART. 1505. Limited partnership as partnership. — So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan

these characteristics, it was to be classified under those regulations as an association. When it lacked all these characteristics, it was to be classified as a partnership. Doubtful cases were to be classified as associations. While the details were not spelled out, apparently an organization with a mixture of association and partnership characteristics was to be classified as an association. The original approach under Regulations 33 pushed everything except a pure partnership into the category of corporations. While Regulations 45 modified that approach in the case of limited partnerships having general partners with unlimited liability and other partnership characteristics, the general approach still swept as many cases as possible into the corporation category.

Regulations 65 were issued under the Revenue Act of 1924.²⁷⁴ The sections "association,"²⁷⁵ "association distinguished from partnership,"²⁷⁶ "limited partnership as partnership,"²⁷⁷ and "limited partnership as corporation"²⁷⁸ are almost identical to the corresponding articles under Regulations 45. The provision distinguishing associations from trusts differs somewhat from the provision under Regulations 45, mainly in the omission of a requirement of control by beneficiaries for association classification.²⁷⁹ This revised provision was intended to reflect the decision

and Illinois limited partnerships are partnerships. A California special partnership is a partnership.

ART. 1506. Limited partnership as corporation. — On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as distributions on the stock of corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership association is a corporation. Such a corporation may or may not be a personal service corporation. . . .

Treas. Reg. 45 (1920 ed. 1921).

274. Cited as *Treas. Reg. 65* (1924).

275. *Treas. Reg. 65*, art. 1502 (1924).

276. *Treas. Reg. 65*, art. 1503 (1924).

277. *Treas. Reg. 65*, art. 1505 (1924).

278. *Treas. Reg. 65*, art. 1506 (1924).

279. *Treas. Reg. 65* (1924):

ART. 1504. Association distinguished from trust. — Holding trusts, in

of the Supreme Court in *Hecht v. Malley*,²⁸⁰ which found that control of the trustees by the beneficiaries was not required.

The provisions issued in Regulations 74,²⁸¹ under the Revenue Act of 1928, are almost the same as the Regulations 65 provisions for "association,"²⁸² "limited partnership as partnership,"²⁸³ and "limited partnership as corporation."²⁸⁴ The provision distinguishing associations from partnerships²⁸⁵ is similar to its predecessor. The changes in this latter provision do not appear to have any great significance. Much of the language added was taken from the section "limited partnership as corporation." A reference to classification as an association, "even though under State law such organizations are technically partnerships," only states explicitly what is otherwise inferred, *i.e.*, that a mere local law label does not control when the organization resembles an association, what-

which the trustees are merely holding property for the collection of the income and its distribution among the beneficiaries, and are not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business, are not associations within the meaning of the law. The trust and the beneficiaries thereof will be subject to tax as provided in articles 341-347. Operating trusts, whether or not of the Massachusetts type, in which the trustees are not restricted to the mere collection of funds and their payments to the beneficiaries, but are associated together in much the same manner as directors in a corporation for the purpose of carrying on some business enterprise, are to be deemed associations within the meaning of the Act, regardless of the control exercised by the beneficiaries.

280. 265 U.S. 144 (1924); see notes 107-12 *supra* and accompanying text.

281. Treas. Reg. 74 (1931).

282. Treas. Reg. 74, art. 1312 (1929).

283. Treas. Reg. 74, art. 1315 (1929).

284. Treas. Reg. 74, art. 1316 (1929).

285. Treas. Reg. 74, art. 1313 (1929):

ART. 1313. Association distinguished from partnership. — An organization, the membership interests in which are transferable and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. The term "partnership" means only ordinary partnerships. Organizations which have a fixed capital stock divided into shares represented by certificates transferable only upon the books of the company, which manage their affairs by a board of directors or executive officers, and which conduct their business in the general form and mode of corporations are joint-stock companies or associations within the meaning of the Act even though under State law such organizations are technically partnerships.

This provision omitted the words italicized in the following phrase from Treas. Reg. 65 (1924): "the membership interests in which are transferable *without the consent of all the members, however the transfer may be otherwise restricted.*" The words beginning with "The term 'partnership' means only ordinary partnerships" were added in Treas. Reg. 74 (1931).

ever its name under local law. No similar statement is made concerning associations classified as partnerships, however. The provision on trusts²⁸⁶ has some changed language, but seems substantially the same as its predecessor. Although this provision picks up some language from Regulations 45,²⁸⁷ the substance of Regulations 65 is continued,²⁸⁸ with the reference to "absence of any control by the beneficiaries" a little more direct and specific.

In Regulations 77, under the Revenue Act of 1932, the sections on "association,"²⁸⁹ "limited partnership as partnership,"²⁹⁰ and "limited partnership as corporation,"²⁹¹ are the same as the corresponding provisions of Regulations 74. The section distinguishing associations from partnerships²⁹² added a word-for-word

286. Treas. Reg. 74, art. 1314 (1931):

ART. 1314. Association distinguished from trust.—Where trustees merely hold property for the collection of the income and its distribution among the beneficiaries of the trust, and are not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business, and the beneficiaries have no control over the trust, although their consent may be required for the filling of a vacancy among the trustees or for a modification of the terms of the trust, no association exists, and the trust and the beneficiaries thereof will be subject to tax as provided by sections 161-170 and by articles 861-891. If, however, the beneficiaries have positive control over the trust, whether through the right periodically to elect trustees or otherwise, an association exists within the meaning of section 701. Even in the absence of any control by the beneficiaries, where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on their business enterprise, the trust is an association within the meaning of the Act.

287. See Treas. Reg. 45, art. 1504 (1920 ed. 1921) (quoted in note 270 *supra*).

288. See Treas. Reg. 65, art. 1504 (1924) (quoted in note 279 *supra*).

289. Treas. Reg. 77, art. 1312 (1933).

290. Treas. Reg. 77, art. 1315 (1933).

291. Treas. Reg. 77, art. 1316 (1933).

292.

ART. 1313. Association distinguished from partnership.—An organization, the membership interests in which are transferable and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. *The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the Act, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture or organiza-*

adoption of the new statutory "definition" of "partnership," provided under the Revenue Act of 1932.²⁹³ Also, the trust provision was changed to eliminate any reference to or consideration of control of the trustees by the beneficiaries in determining association status.²⁹⁴

A major revision of these regulations was made under the Revenue Act of 1934, Regulations 86.²⁹⁵ The provisions "limited partnership as partnership"²⁹⁶ and "limited partnership as corporation"²⁹⁷ remained substantially the same as under Regulations 77 and before. A general section was added setting forth certain general rules for making the classification:

ART. 801-1. Classification of taxables. — For the purpose of taxation the Act makes its own classifications and prescribes its own standards of classification. Local law is of no importance in this connection. Thus a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. (See article 801-3.) The term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. (See article 801-4.) The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships. (See articles

tion. Organizations which have a fixed capital stock divided into shares represented by certificates transferable only upon the books of the company, which manage their affairs by a board of directors or executive officers, and which conduct their business in the general form and mode of corporations are joint-stock companies or associations within the meaning of the Act even though under State law such organizations are technically partnerships.

Treas. Reg. 77 (1933). (Italics added to indicate material added by Regulations 77.)

293. See notes 69-71 *supra* and accompanying text.

294.

ART. 1314. Association distinguished from trust. — Where trustees merely hold property for the collection of the income and its distribution among the beneficiaries of the trust, and are not engaged either by themselves or in connection with the beneficiaries, in the carrying on of any business, no association exists, and the trust and the beneficiaries thereof will be subject to tax as provided by sections 161-170 and by articles 861-891. Where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but have similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the Act.

Treas. Reg. 77 (1933).

295. Treas. Reg. 86 (1935).

296. Treas. Reg. 86, art. 801-6 (1935).

297. Treas. Reg. 86, art. 801-5 (1935).

801-2 and 801-4.) The definitions, terms, and classifications, as set forth in section 801, shall have the same respective meaning and scope in these regulations.²⁹⁸

The above section explicitly states that which was more or less implied in earlier regulations — that local law labels alone do not control. The above regulation also contains what must surely be a great overstatement: “local law is of no importance in this connection.” Reference to local law is necessary in *applying* the tests developed in the regulations, and consequently that reference cannot be deemed to be “of no importance,” or irrelevant. This statement could *only* mean that the *criteria* for determination of the classification are developed only under the internal revenue law, and are not found in local law. But even so limited, the statement on its face is still ludicrous. The first sentence is likewise overstated: “For the purpose of taxation the Act makes its own classification and prescribes its own standards of classification.” Where? In the terse “definitions” which contain hardly more than a list of labels? In the legislative history, which seems only to refer to local law labels? And where do the criteria stated in the regulations come from, if not from local law? Nevertheless, it clearly is reasonable to say that local law labels alone do not control, and that the same criteria for classification shall apply from state to state. The trouble is that the criteria have to come from somewhere — and they are not found in the statute. Presumably the Treasury fashioned these criteria from general observations concerning the various forms of doing business. But those general observations necessarily refer to local law in a general, if not specific, way.

Regulations 86 continue the broad concept of association that seems to be the theme of the early statutes and regulations.²⁹⁹

298. Treas. Reg. 86, art. 801-1 (1935).

299. Treas. Reg. 86 (1935):

ART. 801-2. Association. — The term “association” is not used in the Act in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a “business” trust, a “Massachusetts” trust, a “common law” trust, an “investment” trust (whether of the fixed or the management type), an inter-insurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within

The definition emphasizes continuity of life and centralized management. Presumably the continuity of life test depends not on actual facts, but rather upon whether the form of business organization created avoids discontinuity upon the death, withdrawal, etc. of an owner.³⁰⁰ Also, presumably, centralized management is created by the form of the arrangement, and not by the way the owners act.

The extensive provision distinguishing associations from trusts³⁰¹ mentions several characteristics of corporations: holding

the meaning of the Act, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

300. See notes 46, 85, 127 & 139-44 *supra* and accompanying text.

301. Treas. Reg. 86 (1935):

ART. 801-3. Association distinguished from trust. — The term "trust," as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation.

By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold, and dispose of

title, engaging in business, centralized management (representative management), continuity of existence, ability to sue and be sued, and limitation of liability. The regulation also mentions several less important characteristics which, when present, "serve to emphasize the fact that an organization possessing them should be treated as a corporation"³⁰² but are not necessary for classification as a corporation. These minor characteristics include: designation of officers, use of a seal, issuance of certificates of beneficial ownership, holding of meetings, use of a "charter" or "by-laws," and existence of some control by beneficiaries over the affairs of the corporation. While the definition of association requires only continuity of life and representative management, the trust section refers to "unity of management" and "continuity of existence" as the critical factors. Presumably the different words refer to the same concepts. The trust section also mentions the other

property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other difference of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

302. *Ibid.*

specified characteristics of corporations. Just which combinations of factors will lead to association classification is not clear, but clearly certain combinations do.

The partnership section under Regulations 86 is a little clearer:

ARR. 801-4. Partnerships. — The Act provides its own concept of a partnership. Under the term "partnership" it includes not only a partnership as known at common law but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Act, a trust, estate, or a corporation. On the other hand the Act classifies under the term "corporation" an association or joint-stock company, the members of which may be subject to the personal liability of partners. If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association taxable as a corporation. As to the characteristics of an association, see also articles 801-2 and 801-3.³⁰³

In these definitions limited liability is not *required* for association classification. It is not even mentioned under the association section; is mentioned only as sometimes present in trusts classified as associations;³⁰⁴ and, according to the partnership section, is not found in the typical association or joint-stock company. However, limited liability is characteristic of corporations and appears to be the most significant, perhaps only important, factor mentioned in the section "limited partnership as corporation."³⁰⁵ Altogether Regulations 86 attempt a more systematic, detailed set of rules for making classifications. The characteristics used are found in earlier regulations, although not so highly developed. It

303. The article continues:

The following examples will illustrate some phases of these distinctions:

(1) If A and B buy some acreage for the purpose of subdivision, they are joint adventurers, and the joint venture is classified by the Act as a partnership.

(2) A, B and C each contributes \$10,000 for the purpose of buying and selling real estate. If A, B, C, or D, an outside party (or any combination of them as long as the approval of each participant is not required for syndicate action), takes control of the money, property and business of the enterprise, and the syndicate is not terminated on the death of any of the participants, the syndicate is classified as an association.

Treas. Reg. 86, art. 801-4 (1935).

304. Note 294 *supra*.

305. Treas. Reg. 86, art. 801-5 (1935).

would be difficult to say that any real change of emphasis can be found in Regulations 86, except possibly for the clear statements on the relevancy of the local law labels.

Regulations 94, under the Revenue Act of 1936, continue the provisions of Regulations 86.³⁰⁶ However, language added to the second paragraph of the trust article emphasizes the importance of the instrument in classifying an organization as an association.³⁰⁷

Regulations 101, under the Revenue Act of 1938, continue these provisions unchanged.³⁰⁸ Likewise, Regulations 103, under the Internal Revenue Code of 1939, continue unchanged most of the relevant provisions of Regulations 101.³⁰⁹ While Regulations 103 contain no provision entitled "limited partnership or corporation," two new sections appear entitled "limited partnerships"³¹⁰ and "partnership associations."³¹¹ These new sections continue association classification of limited partnerships when the following elements are present: no interruption of the "organization"

306. Treas. Reg. 94, art. 1001-1 to -6 (1936).

307. Treas. Reg. 94, art. 1001-3 (1936): "The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted."

308. Treas. Reg. 101, art. 901-1 to -6 (1939).

309. Treas. Reg. 103, §§ 19.3797-1 to -4 (1940).

310. Treas. Reg. 103 (1940):

Sec. 19.3797-5. Limited partnerships. — A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership notwithstanding other characteristics conferred upon it by local law.

The Uniform Limited Partnership Act has been adopted in several states. A limited partnership organized under the provisions of that Act may be either an association or a partnership depending upon whether or not in the particular case the essential characteristics of an association exist.

311. Treas. Reg. 103. (1940):

Sec. 19.3797-6. Partnership associations. — A partnership association of the type authorized by the statutes of several states, such, for instance, as those of the State of Pennsylvania . . . , having by virtue of the statutory provisions under which it was organized, the characteristics essential to an association within the meaning of the Internal Revenue Code, is taxable as a corporation.

upon the death or transfer of interest of a general partner, and centralization of management in someone, or some group in a representative capacity.

The relevant portions of Regulations 111, applicable only to years beginning after December 31, 1941, are identical to Regulations 103.³¹²

C. APPLICATION OF THE EARLY REGULATIONS TO THE MODELS

The personal service corporation and the manufacturing corporation would obviously be treated as corporations under all the early regulations. First, the early regulations do not question classification of groups with a corporate charter. Second, these two corporations have every characteristic mentioned in the regulations.

The Colorado professional corporation has an equally certain classification as a corporation — differing only in that this corporation may not ethically do business unless it complies with state supreme court rules.³¹³ However, nothing in the early regulations has anything to do with that difference.

The professional corporation also would be classified as a corporation under the early regulations because of its corporate charter. Furthermore, the professional corporation has all the characteristics of an association or corporation as stated in the regulations. The group certainly is not an ordinary partnership, or limited partnership. Limited liability is an important characteristic of corporations, according to the early regulations, and is prominent, for example, in Regulations 45.³¹⁴ Apparently, limited liability is a critical fact in the classification of limited partnerships under those regulations as a partnership or as a corporation.³¹⁵ Limited liability is also mentioned under Regulations 86³¹⁶ and following versions.³¹⁷ However, explicit mention of limited liability in connection with classification of limited partnerships stopped with Regulations 103.³¹⁸ Perhaps it remained a factor by inference, however. That the precise nature of the extent of limited liability of a professional corporation

312. See Treas. Reg. 111, §§ 29.3797-1 to -6 (1943).

313. COLO. R. CIV. P. 265.

314. Treas. Reg. 45, arts. 1505-06 (1920).

315. *Ibid.*

316. Treas. Reg. 86, art. 801-3 (1935).

317. Treas. Reg. 94, art. 1001-3 (1936); Treas. Reg. 101, art. 901-3 (1939); Treas. Reg. 103, § 19.3797-3 (1940); Treas. Reg. 111, § 29.3797-3 (1943).

318. Treas. Reg. 103, § 19.3797-5 (1940).

is not yet known³¹⁹ seems of no great significance. The regulations do not refer to degrees of limited liability. Since the limitation of liability for the professional corporation is as great or almost as great as the limitation of liability for the manufacturing corporation,³²⁰ for instance, this characteristic is present.

Centralization of management is also a characteristic of the professional corporation.³²¹ This factor remained prominent since Regulations 45, which stated: "the business of which is conducted by trustees or directors and officers without the active participation of all the members as such."³²² Regulations 86 made the following change: "the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity."³²³ The concept of representative capacity appeared also in Regulations 103 and following.³²⁴ The concept of centralization of management as used in these regulations seems more to refer to what centralization the form of organization provides and not to who actually wields the power in a business enterprise. The limited partnership, the trust, and the corporation all seem to have someone or a group acting in a capacity other than principals, apparently thus meeting the requirement of centralization of management in these early regulations. The professional corporation has this characteristic. The board would, no doubt, have control over all aspects of the business of the corporation, whether involving professional decisions or not. The extent to which a particular corporation's board controls the details of performance by all employees will vary, of course, and likely should not be considered in determining whether the characteristic centralization of management is present.³²⁵

Regulations 45 also refer to transferability of interest, in the section entitled "association distinguished from partnership," in these terms: "An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted . . ."³²⁶ The concept is also referred to in the sections on "limited partnership as corpora-

319. See notes 214-17 *supra* and accompanying text.

320. *Ibid.*

321. See notes 195-200 *supra* and 382-87 *infra* and accompanying texts.

322. Treas. Reg. 45, art. 1503 (1920).

323. Treas. Reg. 86, art. 801-2 (1935).

324. Treas. Reg. 103, § 19.3797-2 (1940); Treas. Reg. 111, § 29.3797-3 (1943).

325. See text accompanying notes 382-87 *infra*.

326. Treas. Reg. 45, art. 1503 (1920 ed. 1921).

tion" in the words: "providing for the transferability of partnership shares" ³²⁷ This concept apparently disappears under Regulations 103 and following, but mention of the issuance of certificates to beneficiaries as a minor characteristic of corporations is found in the section, "association distinguished from trust." ³²⁸ Therefore, transferability is of doubtful importance in the early regulations, but as used in those regulations, the professional corporation has transferability. Even if subject to a first offer to the corporation or other shareholders, the shares are still more transferable than a partnership interest, for the transfer does not require the consent of all participants. ³²⁹ This characteristic of a corporation, therefore, also is present.

Another characteristic of corporations found in the early regulations is the so-called continuity of life characteristic. ³³⁰ When a partner dies or transfers his interest, the business will likely go on, of course, just as the business of the corporation goes on when a shareholder dies or transfers his interest. Apparently, therefore, the sort of continuity considered for classification purposes is not the factual one of whether or not the business continues, but rather the formal continuity lost when the partner dies or transfers his interest, causing a technical dissolution of the old partnership and the creation of a new one. ³³¹ As one indication that this change has substance, a new partner will not be personally liable on the debts of the old partnership. ³³²

The professional corporation is not subject to dissolution upon the occurrence of the events which would provide grounds for the dissolution of a professional association. The statute merely provides for the suspending or revoking of the certificate of regis-

327. Treas. Reg. 45, art. 1506 (1920 ed. 1921); Treas. Reg. 86, art. 801-5 (1935); Treas. Reg. 74, art. 1316 (1929); Treas. Reg. 77, art. 1316 (1933); Treas. Reg. 94, art. 1001-5 (1936).

328. *E.g.*, Treas. Reg. 103, § 19.3797-3 (1940).

329. Note 270 *supra*.

330. Entity continuity is mentioned in Treas. Reg. 45, art. 1505 (1920 ed. 1921) ("Such limited partnerships, . . . which are dissolved by the death or attempted transfer of the interest of a general partner, . . ."). The concept is also mentioned in Treas. Reg. 86, art. 801-2 (1935), and following regulations (" . . . which, like a corporation, continues notwithstanding that its members or participants change . . ."), and in Treas. Reg. 86, art. 801-3 (1935) ("the trust form affords the advantages of . . . and continuity of existence . . ."). Finally Treas. Reg. 86, art. 801-4 (1935), also mentions it ("if an organization is not interrupted by the death of a member or by a change in ownership of a participating interest . . .").

331. UNIFORM PARTNERSHIP ACT §§ 30, 31 & 42.

332. UNIFORM PARTNERSHIP ACT § 17.

tration.³³³ Even dissolution would not be an unusual restriction on the life of a corporation,³³⁴ and it would be safe to say that few professional corporations will ever be dissolved involuntarily or have their certificates of registration revoked, whether or not the grounds for involuntary dissolution occur for a time.³³⁵ The professional corporation, therefore, appears to have continuity of life as that concept is used in the early regulations.

Two other characteristics of corporations mentioned in these regulations are centralization of title,³³⁶ and the ability to sue in the name of the organization.³³⁷ Professional corporations obviously have these characteristics.³³⁸ The professional corporation has, therefore, every corporate characteristic, major and minor, mentioned in the early regulations, as well as the further characteristic of corporateness, the corporate charter.

The professional association also has each of the characteristics mentioned in the regulations except the corporate charter. Because of the more doubtful extent of limited liability conferred on a professional association,³³⁹ this characteristic may be present in a diminished form. Yet, arguably, however the courts ultimately define the extent of its limited liability, the professional association form still provides substantial limited liability, even though confined to debt only. Limited debt liability could have substantial significance in the acquisition of extensive equipment, or of a clinic building. One could further argue and predict that these associations will be given, and indeed already have, substantial limited liability in the area of professional negligence.³⁴⁰

Whether the limited liability characteristic is present in full, almost in full, or only in part is not important. The professional association has so many other characteristics of a corporation that its classification as a corporation for tax purposes is clear even without limited liability. The early regulations never suggested that an organization had to have anywhere near all the corporate characteristics discussed. Under the earliest regulations mere use of the name "association" and formation of the enterprise under an "association" statute was enough to compel

333. MINN. STAT. § 319.12 (1961).

334. See note 373 *infra*.

335. See text accompanying notes 369-76 *infra*.

336. *E.g.*, Treas. Reg. 86, art. 801-3 (1935).

337. *E.g.*, *ibid*.

338. Professional corporations are covered by the Minnesota Business Corporation Act., MINN. STAT. §§ 300.08(2), .08(4) (1961).

339. See text accompanying notes 396-98 *infra*.

340. See text accompanying notes 395-403 *infra*.

association classification.³⁴¹ Under Regulations 45, association status required only (1) membership interests which were transferable without the consent of all the members, however the transfer was otherwise restricted; and (2) conduct of the business of the association by trustees or directors and officers without the active participation of all the members as such.³⁴² Obviously both requirements are present for the professional association. Under another section of Regulations 45 distinguishing limited partnerships and corporations,³⁴³ again the professional association would be classified as a corporation and not as a partnership. All the mentioned characteristics are present — limited liability, transferability of shares, capacity to hold real estate, and the ability to bring suit in the common name.

Regulations 86 and those following mention the factors of continuation of the organization even though its members change, and management is by a group acting in a representative capacity³⁴⁴ — almost the same factors as in the earlier regulations. Apparently, continuity of life is substituted for transferability of interest in the section defining "association."³⁴⁵ Limited liability is not even mentioned in that section. Also, these regulations apparently give effect to agreements by the parties defining the structure of the organization. Local law is flexible enough concerning centralization of management and transferability of interests, and perhaps even as to continuity of life, so that these characteristics could be provided by a trust instrument, by partnership articles, or by articles of association. Of course, local law is not quite so flexible with regard to limited liability, centralization of title, and the capacity to sue in the name of the organization. Whether such agreements by the parties can *limit* a characteristic that is normally present, such as the transferability and limited liability characteristics of corporations, is not discussed. In conclusion, the professional association would be characterized as an association under these early regulations, applied at face value.

The early regulations seem to be consistent with what little guidance the statutes and the legislative history provide, and the cases tend to follow the regulations generally and to sweep doubtful cases into the association category. These regulations received explicit approval in the cases generally, and in particular in the

341. Treas. Reg. 33, art. 58 (rev. 1918).

342. Treas. Reg. 45, art. 1503 (1920 ed. 1921).

343. Treas. Reg. 45, art. 1506 (1920 ed. 1921).

344. Treas. Reg. 86, art. 801-2 (1935).

345. *Ibid.*

Morrissey group of Supreme Court cases.³⁴⁶ Since these regulations are largely consistent, and therefore long standing, since they were issued contemporaneously with many of the sections they interpret, and since they received uniform approval by the courts, it would be safe to say that they acquired the status of "force of law" in the sense that the courts gave them great weight. Any later changes in the regulations must therefore be viewed in the light of this long history of the early regulations and the acceptance they found in the courts.

D. THE "KINTNER" REGULATIONS

*United States v. Kintner*³⁴⁷ was an important victory for taxpayers who longed for the tax advantages of the corporate form, but were not permitted to adopt it. At first the Internal Revenue Service announced it would not follow the *Kintner* decision.³⁴⁸ Later the service announced its position was changing and a ruling would be issued redefining the criteria for classifying an association for tax purposes as a corporation.³⁴⁹ Regulations were proposed in 1959³⁵⁰ and final regulations, the so-called "Kintner" Regulations, were proclaimed in 1960.³⁵¹ From the beginning, clearly a more appropriate title for these regulations would be the "anti-Kintner" Regulations.

The regulations begin with a statement of standards to be followed:

(b) *Standards.*—The Internal Revenue Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, which are to be applied in determining the classification in which an organization belongs (whether it is an association, a partnership, a trust, or other taxable entity) are determined under the Internal Revenue Code. Sections 301.7701-2 to 301.7701-4 set forth these tests, or standards, which are to be applied in determining whether an organization is (1) an association (see § 301.7701-2), (2) a partnership (see § 301.7701-3), or (3) a trust (see § 301.7701-4).

(c) *Effect of local law.*—As indicated in paragraph (b) of this section, the classes into which organizations are to be placed for pur-

346. See notes 114-15 *supra* and accompanying text.

347. 216 F.2d 418 (9th Cir. 1954); see notes 162-74 *supra* and accompanying text.

348. Rev. Rul. 56-23, 1956-1 CUM. BULL. 598.

349. Rev. Rul. 57-546, 1957-2 CUM. BULL. 886.

350. 24 Fed. Reg. 10450 (1959).

351. Treas. Reg. §§ 301.7701-1 to -11 (1960), T.D. 6503, 1960-2 CUM. BULL. 409 (amended by, T.D. 6797, 1965 INT. REV. BULL. No. 9, at 38).

poses of taxation are determined under the Internal Revenue Code. Thus, a particular organization might be classified as a trust under the law of one State and a corporation under the law of another State. However, for purposes of the Internal Revenue Code, this organization would be uniformly classed as a trust, an association (and, therefore, taxable as a corporation), or some other entity, depending upon its nature under the classification standards of the Internal Revenue Code. Similarly, the term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. See § 1.761-1 of this chapter (Income Tax Regulations) and § 301.7701-3. The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, and an insurance company. Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.³⁵²

These provisions do a good job of resolving the problem of where one looks for the criteria for determining the classification of an organization, and also avoid the absurd "local law is of no importance" position taken, at least in those words, in the preceding regulations.³⁵³ These provisions point to federal standards, while relying upon local law to determine whether the particular characteristic is present in the case. For example, limited liability is one of the standards, but obviously one must consult local law to determine whether limited liability exists in the particular case.

The section intended to set forth the criteria for classification of a business organization as an association begins as follows:

§ 301.7701-2 ASSOCIATIONS. — (a) *Characteristics of corporations.* —

(1) The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by

352. Treas. Reg. § 301.7701-1(b) to -(c) (1960), T.D. 6503, 1960-2 CUM. BULL. 412.

353. See note 298 *supra* and accompanying text.

taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case. In addition to the major characteristics set forth in this subparagraph, other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust. An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. See *Morrissey et al. v. Commissioner* (1935) 296 U.S. 344³⁵⁴

There seems to be some change in emphasis here. Under the early regulations, the intent was to sweep doubtful cases into the association classification. Therefore, one found statements such as the following in Regulations 45: "In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized."³⁵⁵ This provision stayed in the regulations until Regulations 103, in which more neutral language was used,³⁵⁶ although approximately the same tests as before were specified.

1. *Continuity of Life*

Continuity of life is the first characteristic of corporations discussed under the Kintner Regulations:

(b) *Continuity of life*.—(1) An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any members will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. If the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, unless the remaining general partners agree to continue the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist. See *Glensder Textile Company* (1942) 46 B.T.A. 176 (A., C.B. 1942-1, 8).

(2) For purposes of this paragraph, dissolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law. For example, since the resignation of a partner from a general partnership destroys the mutual agency which exists between such partner and his copartners and thereby alters the personal relation between the partners which constitutes the identity of the partnership itself, the resignation of a partner dissolves the partnership. A corporation, however, has a continuing identity which is detached from the

354. Treas. Reg. § 301.7701-2(a) (1960), T.D. 6503, 1960-2 CUM. BULL. 413.

355. Treas. Reg. 45, art. 1506 (1920 ed. 1921).

356. Treas. Reg. 103, § 19.3797-5 (1940).

relationship between its stockholders. The death, insanity, or bankruptcy of a shareholder or the sale of a shareholder's interest has no effect upon the identity of the corporation and, therefore, does not work a dissolution of the organization. An agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization. Thus, there may be a dissolution of the organization and no continuity of life although the business is continued by the remaining members.

(3) An agreement establishing an organization may provide that the organization is to continue for a stated period or until the completion of a stated undertaking or such agreement may provide for the termination of the organization at will or otherwise. In determining whether any member has the power of dissolution, it will be necessary to examine the agreement and to ascertain the effect of such agreement under local law. For example, if the agreement expressly provides that the organization can be terminated by the will of any member, it is clear that the organization lacks continuity of life. However, if the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life.³⁵⁷

This provision differs considerably from the earlier provision. For one thing, the meaning of continuity of life is spelled out in great detail, whereas the earlier formulation was as simple as "which are dissolved by the death or attempted transfer of the interest of a general partner"³⁵⁸ and "which, like a corporation, continues notwithstanding that its members or participants change . . ."³⁵⁹ The point clearly is made that the concept of continuity is a technical, entity, identity concept, apparently having nothing to do with whether the "business" in fact carries on. The entity interpretation of the continuity of interest criterion has some merit, if this criterion is to be used at all in these classification problems. The only real determinants of whether a business continues on the occasions specified are not the legal forms at all, but rather entirely such factors as who died, who remains, what the relative contribution of each may have been or will be,

357. Treas. Reg. § 301.7701-2(b) (1960).

358. Treas. Reg. 45, art. 1505 (1920 ed. 1921).

359. Treas. Reg. 86, art. 801-2 (1935).

and the general health of the business. It is most doubtful that the form has anything to do with continuity of the business in the real, ordinary sense. The parties to a partnership agreement, for example, may agree to carry on the business,³⁶⁰ and it will not, therefore, have to be liquidated or sold but may continue with a minimum of disruption. The partnership continues for tax purposes.³⁶¹ Arguably, from all this, since continuity of life has nothing to do with the form used, it should not be considered in classifying organizations into one form or another. Or possibly one should look to the actual facts; if continuity appears, one finds a characteristic of corporations. However, the latter approach requires extensive fact finding, probably not justified for this purpose. On the other hand, continuity is a technical, entity concept, and is arguably relevant to the classification issue because corporations appear to have continuity of the entity, and partnerships in their natural state do not.

One who approaches the classification issue factually, looking for certain facts that appear when a corporation is found, would probably conclude that continuity is irrelevant, since it depends on factors quite apart from whether there is corporateness. Obviously, a small business has the same chance for continuing in business whether it operates under the form of a corporation or the form of a partnership. To say that today one form provides more actual continuity than the other simply makes no sense. Perhaps the situation was otherwise when the question of classification for tax purposes first arose. But today no practical difference exists for the prediction of which form will make survival more likely. Consequently, any factual justification of the continuity criterion must be rejected.

The technical entity approach to continuity of life remains — assuming for the moment the relevance of the continuity criterion. *Some* consequences differ depending on the form used. A “dissolution” of a partnership takes place at the will of a partner, when he dies or when his interest is otherwise transferred.³⁶² Although the old partnership is dissolved, under the articles a new partnership probably is created without the business missing a breath. The withdrawing partner, however, as a result of the dissolution and notice to creditors, has no liability for debts incurred after the dissolution,³⁶³ and the new partner has no personal liability for

360. UNIFORM PARTNERSHIP ACT § 41.

361. INT. REV. CODE OF 1954, § 708.

362. UNIFORM PARTNERSHIP ACT § 31.

363. CRANE, PARTNERSHIP § 81 (2d ed. 1952).

debts of the business incurred before he became a partner.³⁶⁴ The corporation entity, in contrast, continues unchanged upon such occasions. Furthermore, the rights of the parties and their powers over one another vary somewhat on these occasions. The partner has a right to an accounting³⁶⁵ — a substantial bundle of rights — while the shareholder has only the uncertain remedy of a derivative suit — ordinarily not a substantial bundle of rights.³⁶⁶ The shareholder will have a limited access to the books and records, of course.

All these considerations might lead one to conclude that the criterion of continuity of life is not valid. The first difference, liability for debts, is only a question of whether there is personal liability or not, and when it is cut off. The second may be a characteristic of corporations by itself — that is, the particular rights of the beneficial owners with respect to the other owners and those managing the business — and not a reason to support the relevance of the general criterion, continuity of life. The more the concept is examined, the softer it appears. Thus, one questions its relevance to the classification issue. The relevance is nowhere expressed in the regulations except by a reference to “pure” corporations having it.

Even if continuity of life in one form or another is relevant, how important is it? The legislative history to the early revenue acts suggests there was once some importance. But if continuity of life was an important advantage in the early days to use of the corporate form, is it today? Considering the continuity that may be achieved under the partnership form, who would counsel a client to use the corporate form because of the advantage of continuity of life? Another difficulty is that the court in *Kintner* found continuity of life in that situation,³⁶⁷ presumably in the agreement between the members. But the agreement could not provide any more continuity than a partnership agreement could provide. If the Kintner group was a partnership under local law, it was still probably subject to dissolution, notwithstanding the agreement. If it was a partnership, therefore, the Kintner group had no continuity as defined in the Kintner Regulations. The question remains, what continuity did it have? One answer is that the agreement provided continuity, and it is that type of

364. *Id.* § 88.

365. UNIFORM PARTNERSHIP ACT § 22.

366. See 2 O'NEAL, CLOSE CORPORATIONS §§ 8.07-08 (1958), for some examples of what can happen to a minority shareholder and the uncertainty of his remedies.

367. 216 F.2d at 422-23.

continuity rather than entity continuity that the court had in mind. Professor Sneed's analysis used a similar approach. Apparently, therefore, that concept in the Kintner Regulations is quite different from the concept of continuity in *Kintner* and the concept of avoiding discontinuity in the early regulations. In summary, continuity appears at the most a rather minor technical characteristic, if relevant at all.

If the technical entity approach of the Kintner Regulations is adopted, the effect on the various models must be examined. The closely-held personal service corporation will no doubt have the continuity required under the regulations, no matter how stable or unstable the relationship of the people concerned may be. The professional association statutes,³⁶⁸ and of course the professional corporation statutes,³⁶⁹ provide for continuation of the entity with no technical dissolution upon the death, insanity, retirement, etc. of a member. Some questions have been raised about whether such organizations really have the required continuity, since the state is given the power to dissolve the association or revoke the certificate of registration of the corporation for failure to comply with certain requirements—for instance, failure to expel a member who has been disqualified to practice, or inability or failure to purchase shares coming into the hands of an unqualified shareholder.³⁷⁰ It has also been suggested that under these provisions a member's death, bankruptcy, or retirement may imperil the life of the professional association or corporation.³⁷¹ The objection is mostly a matter of conjuring up difficulties of no great substance. Actual dissolution is most unlikely to come from these provisions. First, there seldom will be cause for the dissolution, since normally there will be a buy-out agreement, or other provision made to avoid disqualifying events. Second, even in the rare case of *cause* for the dissolution, such a drastic remedy obviously will be taken only as a last resort, after considerable negotiation and opportunity to remove the difficulty providing cause for dissolution. Third, nothing in the early regulations, the Kintner Regulations, or the cases even suggests that the continuity looked for, or sought to be avoided, depends upon the presence of such a remedy. Clearly, the concept refers to

368. *E.g.*, GA. CODE ANN. § 84-4309 (Supp. 1963).

369. *E.g.*, MINN. STAT. § 319.05 (1961) provides for general applicability of Minnesota law on corporations. MINN. STAT. § 301.04(2) (1961) states that the duration of a corporation may be perpetual.

370. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1, 15-17 (1961).

371. *Id.* at 16.

continuity upon, for instance, the death or other withdrawal of the owner of a beneficial interest rather than the state's theoretical power to dissolve completely the business upon the occurrence of some relatively unlikely event. The concept properly applied, therefore, concerns an occasion that rather automatically causes dissolution, not a remote possibility of dissolution as a result of subsequent proceedings brought by the state. Fourth, the state's power to dissolve a corporation is not an unusual one, even if infrequently invoked. *Any* corporation is subject to that power under certain typical statutory provisions.³⁷² A multitude of provisions specify, and cases find, *power* to dissolve for various reasons.³⁷³ In these instances the provision for dissolution is not self-executing, but the dissolution occurs only upon conclusion of a judicial proceeding brought by an officer of the state. The shareholders may, of course, dissolve the corporation for any reason, and it is not unusual to do so when a deadlock is reached on important questions.³⁷⁴ The insolvency of a corporation may not cause technical dissolution, but the creditors may obtain almost the same rights they would obtain under a technical dissolution.³⁷⁵ Consequently, the insolvency of a corporation may be considered a *de facto*, or practical dissolution. Every corporation, therefore, is subject to voluntary and involuntary dissolution. Some corporations, which involve the public interest, are subject to dissolution for specified reasons that usually apply only to the particular class of corporations.

Arguably, a "pure" or average corporation is not subjected to even the threat of dissolution for such things as are specified by the professional association and corporation statutes, and therefore these organizations lack continuity to some extent.³⁷⁶ However, that assertion begs the question. Nothing in the statute, legislative history, the early regulations, or the cases makes a "pure" corporation, whatever that may be, the model for corporateness. The professional corporation and association provisions are well within the range of typical regulatory provisions applicable to corporations in which the public has a greater than average interest. Furthermore, the professional corporation pro-

372. See, e.g., MINN. STAT. § 301.49 (1961).

373. For example, failure to make reports or pay taxes, or the commission of a crime are reasons for dissolution. 16A FLETCHER, PRIVATE CORPORATIONS §§ 8045, 8052 (perm. ed. rev. repl. 1962). See generally *id.* §§ 6690, 7999, 8036, 8045-46, 8052-57, 8065, 8067, 8069 & 8072.

374. 2 O'NEAL, CLOSE CORPORATIONS § 9.03, at 170 (1958).

375. 16A FLETCHER, *op. cit. supra* note 373, § 7967, at 10-11.

376. Bittker, *supra* note 370, at 15.

vision is for revocation of the certification of registration, not for dissolution. In any event, these professional corporations and associations do have substantial continuity upon the events which normally cause automatic dissolution of a partnership, since any dissolution which can occur is not likely, nor automatic, nor immediate.

2. *Centralization of Management*

The Kintner Regulations provide:

(c) *Centralization of management.*—(1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation. The effective operation of a business organization composed of many members generally depends upon the centralization in the hands of a few of exclusive authority to make management decisions for the organization, and therefore, centralized management is more likely to be found in such an organization than in a smaller organization.

(2) The persons who have such authority may, or may not, be members of the organization and may hold office as a result of a selection by the members from time to time, or may be self-perpetuating in office. See *Morrissey et al. v. Commissioner* (1935) 296 U.S. 344 Centralized management can be accomplished by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

(3) Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

(4) There is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions. For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, simply because he is a stockholder or beneficiary, from binding the corporation or the trust by his acts. However, because of the mutual agency relationship between members of a general partnership subject to a statute corresponding to the Uniform Partnership Act, such a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management. Usually, the act of any partner within the scope of the partnership business binds all the partners; and even if the partners agree among themselves that the powers of management shall be exclusively in a selected few, this agree-

ment will be ineffective as against an outsider who had no notice of it. In addition, limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners.³⁷⁷

These provisions differ considerably from the early regulations and cases. In some of the cases the requisite centralization of management was found even when all of the beneficial owners were active in the management.³⁷⁸ Furthermore, although the earliest regulations refer to the business being conducted by less than all the members or owners,³⁷⁹ the later regulations put emphasis on the *representative capacity* of those who conduct the business,³⁸⁰ not the relative number of persons involved. This language of the later regulations also seems more consistent with the cases which found centralized management without regard to whether less than all the owners were involved in management. Moreover, the later regulations are more consistent with the *Kintner* case, where in all probability the group was a partnership under local law, and therefore, theoretically all the owners could be involved in management. The centralized management of the preceding regulations and cases, therefore, seems to depend upon whether the parties adopted a form which necessarily involves technical or formal delegation, such as provided by the trust and corporation forms, or whether they have in fact adopted centralized management in their governing articles as a way of establishing their internal relationships. One finds no general support for Regulation section 301.7701-2(c)(4), which states that a partnership cannot achieve centralized management, because any partner can bind the others even if he has agreed not to do so.

Although centralized management in fact *is* a function of size, the centralized management discussed under the early regulations and cases is apparently not dependent upon size. Consequently, it is difficult to square the observation that size is a likely indication of centralized management,³⁸¹ with the whole theory of the Kintner Regulations, that the concept is a highly formal one.

A greater problem is to find the relevance of the concept of centralized management to the classification problem. It seems

377. Treas. Reg. § 301.7701-2(c) (1960).

378. *Commissioner v. Coleman-Gilbert Associates*, 296 U.S. 369 (1935); *Swanson v. Commissioner*, 296 U.S. 362 (1935); *Foreman v. United States*, 332 F. Supp. 134 (S.D. Fla. 1964).

379. Treas. Reg. 45, art. 1503 (1920 ed. 1921) (quoted in note 270 *supra*).

380. Treas. Reg. 86, art. 801-2 (1935) (quoted in note 299 *supra*).

381. Treas. Reg. § 301.7701-2(c)(1) (1960).

very doubtful that the form of business used has anything to do with *real* centralized management, which obviously is a function of size, and apart from size depends entirely upon the personalities of the various participants and their relative power in the organization. The more technical definition of centralized management may have some value as a way of describing some differences in the various forms of doing business, but these differences can be reduced by arrangement between the owners. The approach of the Kintner Regulations has the advantage of being easy to apply to particular cases (partnerships can never have centralized management; apparently trusts always do), but these regulations are inconsistent with the early regulations and cases which did find centralized management in the agreements between the participants.

On the question of whether professional associations and corporations have centralized management, it has been argued that the traditional responsibility of each professional to his patient or client makes centralized management impossible,³⁸² and further, that the professional's responsibility to a state licensing or regulating board interferes with centralized management.³⁸³ The objection asserts that centralized management is not concerned with housekeeping details alone, but must involve professional decisions, and on these professional decisions centralized management cannot be achieved.

What might be housekeeping functions, in contrast to the professional decisions, that supposedly cannot be subjected to centralized management? Normally a professional association or corporation would set up standard procedures for determining what patients or clients will be accepted and how they will be assigned to professionals; in the case of a medical practice, consideration might be given to what lab tests and other procedures will be done in the office, how they will be done, what tests will be referred out, how consultations will be handled, how records are to be kept, what fees are to be charged, and what salaries are to be paid. Management might also be responsible for hiring and firing nurses and clerical personnel; perhaps even the hiring of doctors would be entrusted to a management committee, or board of directors, but not necessarily if the group is small. Setting of salaries probably would in fact be negotiated in a small group; in a larger group the board of directors might actually set salaries. All of those matters might be characterized as housekeeping details, or they might be said to be management functions of im-

382. Bittker, *supra* note 370, at 14.

383. *Ibid.*

portance in a professional organization. Handing over that much of the affairs of the group to a representative managing group is considerable centralization of management. Nothing in the cases or the early regulations, or in the Kintner Regulations, suggests that more is required. It is argued, however, that the nature of the professional relationship places so many decisions of a management character outside the authority of the management group as to substantially remove the requisite centralization. Since the statutes explicitly preserve the professional relationship and responsibility, it is said that the legislature intended the professional to make important decisions by himself, in disregard of a judgment of a board of directors, if necessary.³⁸⁴

The assertion that these groups have no control over professional decisions is not necessarily true and not in accord with the facts. A board of directors of a professional association or corporation may have, and may exercise, considerable control over professional decisions. Since an association may become liable for the professional acts of its members, it certainly has the *authority* to control those acts. In routine matters the management does not care greatly about how professional decisions are made, so long as the quality is generally acceptable and the productivity sufficient. But in the important, unusual case, when professional judgment is important, management may very well become involved. Normally, the professional would call in his colleagues, or his senior, to discuss important matters of professional judgment. A difficult decision about whether to operate, whether to use a dangerous or experimental method, would clearly be within the authority of the board, if it wishes to exercise that authority, and the decision might very well be made by the board. After all, the liability of the group is involved in these professional decisions. Whether the board does act will vary from group to group and from case to case. In some groups, professional centralized management in fact will be heavy, in others light. Also, whether a board, or an executive or management committee of a partnership, exercises such authority is almost entirely a matter of personality, power, and relationship of those concerned. Such professional, centralized management is not unusual in law firms, as anyone who has practiced law should know.

However, centralization in fact is not what is required for corporateness. The Kintner Regulations look for centralization in the form of the organization as specified under local law; the cases look as well to the grant of authority in the agreement of

384. See Note, 75 HARV. L. REV. 776, 782 (1962).

the parties. Both searches for centralized management are directed toward authority, not how the group works in day to day activities. The search for centralized management is illusive enough without sinking into such a bog of facts.

Since centralization of management is a shaky basis for classifying professional or any other groups for tax purposes, it serves no useful purpose to put too much strain on the concept if it is to be used. The Kintner Regulations adopt a technical approach to the question with the view that a partnership cannot have centralized management. The technical approach has utility, for it avoids a search for the facts, and the highly technical approach of the Kintner Regulations even provides some basis for election of tax classification. Even if the regulations are valid on this point, the professional association or corporation appears to have centralized management because the law provides for a board of directors to have authority to manage the affairs of the group. If the regulation is not valid, then such a group may achieve centralization by contract, and the professional associations and corporations have centralization a fortiori. Some rulings support the analysis that these groups have technical centralized management. Revenue Ruling 61-178³⁸⁵ held a physician to be an employee of a business corporation rather than an independent contractor for social security and withholding tax purposes. The ruling observed that this employee-physician is subject to supervision "as to the manner in which his services are to be performed."³⁸⁶ In rulings on the tax status of professional groups, the service has stated that control over general policies and general standards is sufficient.³⁸⁷ If the concept of centralized management is to be used for classification, control over general policies, procedures, and standards should be sufficient. An exploration into how much the board tells the doctor to do is not required by law, regulation, cases, or reason. A slight difference in degree of actual control should not be elevated to a compelling policy reason for classification one way or the other.

3. *Limited Liability*

The Kintner Regulations provide:

(d) *Limited liability*.—(1) An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organiza-

385. 1961-2 CUM. BULL. 153.

386. 1961-2 CUM. BULL. 154.

387. *Ibid.*; Special Ruling, March 2, 1961 (Colony Medical Group), 2 CCH PENSION PLAN GUIDE (2d ed.) ¶ 12927 (1962).

tion. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim. A member of the organization who is personally liable for the obligations of the organization may make an agreement under which another person, whether or not a member of the organization, assumes such liability or agrees to indemnify such member for any such liability. However, if under local law the member remains liable to such creditors notwithstanding such agreement, there exists personal liability with respect to such member. In the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to each general partner. Similarly, in the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner, except as provided in subparagraph (2) of this paragraph.

(2) In the case of an organization formed as a limited partnership, personal liability does not exist, for purposes of this paragraph, with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a "dummy" acting as the agent of the limited partners. Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners. Also, if a corporation is a general partner, personal liability exists with respect to such general partner when the corporation has substantial assets (other than its interest in the partnership) which could be reached by a creditor of the limited partnership. A general partner may contribute his services, but no capital, to the organization, but if such general partner has substantial assets (other than his interest in the partnership), there exists personal liability. Furthermore, if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization. In addition, although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not merely a "dummy" acting as the agent of the limited partners.³⁸⁸

This section appears reasonable. The personal liability of a partner for obligations of the partnership is imposed by operation of law; it cannot be avoided by agreement between the partners. Although some of the cases are a little fuzzy, limited liability, whenever present, is recognized as a characteristic of corporate-ness.³⁸⁹ It was so recognized in the early legislative history.³⁹⁰

388. Treas. Reg. § 301.7701-2(d) (1960).

389. Notes 130, 146-55 *supra* and accompanying text.

390. See note 46 *supra* and accompanying text.

Although the early regulations do not go into much detail on limited liability, this provision in the Kintner Regulations seems consistent with them. Interestingly, however, the Kintner group of doctors asserted limited liability, but in fact probably had none.

Unquestionably, a partner's liability is without limit for the torts and debts of the partnership, including torts and debts of the partnership arising out of the conduct of the partnership's business by another partner or an employee of the partnership.³⁹¹ Likewise, the limited liability of a corporate shareholder is clear—he is not personally liable for any debt or tort arising out of the conduct of the corporation's business.³⁹² If a tort is committed by another employee, he will not have to worry about his personal assets being jeopardized. If he commits the tort himself, however, he remains personally liable even though the corporation is also liable.³⁹³ But his liability does not arise out of his status as shareholder; it comes from his position as the tortfeasor.

The professional corporation apparently does enjoy limited liability.³⁹⁴ Some questions have been raised, however, as to whether the professional association enjoys limited liability.³⁹⁵ The difficulty arises out of provisions such as Section 7 of the Georgia Professional Association Statute, quoted and discussed above.³⁹⁶ Clearly, a shareholder has limited liability for the debts of such an organization.³⁹⁷ However, it is argued, section 7 subjects the doctor-shareholder to unlimited liability for the most significant risks of the professional business, and gives him immunity from only the less substantial risks. It follows, the argument goes, that the degree of limited liability required by the regulations is not present.³⁹⁸ This argument includes the assertion that section 7 changes nothing with respect to a professional's liability for the torts of the corporation caused by the professional negligence of other doctor-employees of the association.

Section 7 also raises the problem whether the doctor-member of an association would be liable to a patient or client for the

391. UNIFORM PARTNERSHIP ACT §§ 13, 15.

392. MINN. STAT. § 301.19 (1961).

393. See generally BALLANTINE, CORPORATIONS § 112 (rev. ed. 1946).

394. See text accompanying notes 214–17 *supra*.

395. Bittker, *supra* note 370, at 8–13.

396. GA. CODE ANN. § 84-4307 (Supp. 1963); see text accompanying notes 8–24 *supra*. The provision is extensively discussed in Grayck, *Professional Associations and The Kintner Regulations: Some Answers, More Questions, and Further Comments*, 17 TAX L. REV. 469, 473–98 (1962).

397. GA. CODE ANN. § 84-4307 (Supp. 1963); see text accompanying note 22 *supra*; Bittker, *supra* note 370, at 8–13.

398. Bittker, *supra* note 370, at 8–13.

failure to achieve his promised cure or result³⁹⁹ — seemingly not an important point as these cases are rare. However, if the doctor-employee of a professional corporation is liable on certain warranties, it is not as a shareholder, but rather as an employee. Consequently, his limited liability as a shareholder is not impaired.⁴⁰⁰

The most probable interpretation of section 7 is that the professional who is a member of an association merely retains his common law liability for torts he personally commits. This narrow construction does not affect the limited liability of the doctor as shareholder or as employee, and seems most consistent with the language of the provision. The most prominent difficulty with this interpretation is that the legislature is not likely to restate what is already law in such a statute.

Another interpretation might be that the statute saves certain forms of personal liability, such as liability for failure to produce a promised result or vicarious liability for the negligence of an assistant under the doctor's control.⁴⁰¹ If the statute was intended to add anything to the normal liabilities of an employee, this is the most plausible interpretation. However, such liabilities would attach not because the professional is a *shareholder*, but rather because he is a person who is practicing a particular profession. A *nonshareholder*-employee might be liable on a warranty for cure, and for negligence of an assistant. This language, if it adds anything, clarifies the liability of the professional *employee* on these grounds, but has nothing to do with his status as a *shareholder* and consequently cannot be said to diminish limited liability of shareholders. Furthermore, the evidentiary and financial responsibility policies served by those rules of vicarious liability are served just as well by imputing the negligence of the assistant, for example, to the group.

A further possible interpretation of provisions like section 7 is that the professional retains liability for any tort of a colleague if he participated in rendering any services out of which the tort arose, whether or not he is himself to blame.⁴⁰² In other words if a doctor, without negligence, participates in treatment of a patient, and another doctor in the group is negligent in the course of the treatment, both are personally liable, while a third doctor who did nothing on the case would not be liable. This would be a strained interpretation with no apparent justification for its

399. Bittker, *supra* note 370, at 10; Note, 75 HARV. L. REV. 776, 781 (1962).

400. *Id.* at 781 n.36.

401. Note, 75 HARV. L. REV. 776, 781 (1962).

402. *Ibid.*

different treatment of the two blameless doctors.

Finally, the suggestion has been made that the words and intent of section 7 go all the way by preserving the liability of partners in all tort matters arising out of professional services.⁴⁰³ The statute itself does not seem to so state; such an intent is doubtful; and such a holding by any high court of a state is most unlikely.

The relevance of the limited liability criterion is apparent. Perhaps in most cases today it is the only criterion of corporateness that has any practical significance. Though not required for corporate classification,⁴⁰⁴ no one should make the mistake of concluding that it is, therefore, less important than other characteristics.⁴⁰⁵ Rather, limited liability is ordinarily the only substantial reason, outside of tax considerations, for selecting the corporate form, and its presence is strong evidence that a corporation or association is present.⁴⁰⁶ The professional corporation operates under a much clearer provision on limited liability and, therefore, probably has that characteristic. Consequently, both professional associations and professional corporations appear to have limited liability, as that concept is used in the regulations and the cases.

4. *Free Transferability of Interests*

The Kintner Regulations provide:

(e) *Free transferability of interests*.—(1) An organization has the corporate characteristic of free transferability of interests each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization. Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization. Furthermore, al-

403. Bittker, *supra* note 370, at 9-10.

404. For instance, it was not present in the *Kintner* case, and yet the group was classified as an association. In addition, see Professor Sneed's analysis of these factors. Sneed, *More About Associations in the Oil and Gas Industry*, 33 TEXAS L. REV. 169, 191 (1954).

405. *But see, e.g.*, Note, 12 STAN. L. REV. 746, 758-59 (1960).

406. Almost any so-called corporate characteristic—centralized management, transferability of shares, division of profits with preferences to certain owners for income or assets in liquidation, etc.—can be imparted to a partnership by agreement.

though the agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.

(2) If each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.⁴⁰⁷

Transferability in the above quoted regulations is not consistent with the concept as it appears in the cases and preceding regulations. Transferability as discussed in the cases may be created by agreement of the parties notwithstanding the local law of transferability of beneficial interests.⁴⁰⁸ Regulations 45 spoke of "an organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted . . ."⁴⁰⁹ Rather than an emphasis on less than all the owners consenting to transfer, the Kintner Regulations require that each member be able by himself to transfer his entire interest, or substantially all of his interests, which must include his right to participate in management. Because of this requirement and also the specification of no free transferability upon dissolution of the old organization, a partnership cannot possibly have this characteristic under the Kintner Regulations. The latter specification, which, more simply stated, says that no continuity means no transferability, is a non sequitur. No reason is offered for this limitation. Furthermore, no logic seems to support saying on one hand that a partnership agreement can never provide transferability but that restrictions in corporate bylaws or in a buy-out agreement can take it away.

Also, the regulation recognizes a first option arrangement as providing transferability in a modified form. There was never such a limitation or restriction of the concept in earlier regulations; and the provision in Regulations 45 is rather specific in suggesting that other restrictions are of no importance in weighing whether there is transferability.

The relevance of transferability to corporateness is doubtful today. On the one hand, partnership interests can be easily transferable while, on the other, closely held corporation stock

407. Treas. Reg. § 301.7701-2(e) (1960).

408. See text accompanying notes 158-59, 177 & 181-82 *supra*.

409. Treas. Reg. 45, art. 1503 (1920 ed. 1921).

is notoriously untransferable. The provision in the regulations that a partnership has no transferability when a transfer causes technical dissolution is wholly arbitrary and unsupported. A partnership can make its interests transferable by agreement. The truth of the suggestion that free transferability is ludicrous for most professional groups⁴¹⁰ depends on how one defines his concept of transferability and then upon how he applies it.

A further suggestion is that the restrictions on qualifications of a shareholder in a professional corporation or association and the inevitable buy-out agreement limit transferability. The professional corporation and association statutes do provide for transferability, however, within the group of licensed physicians in the state concerned. Therefore, the shares are transferable so far as local law is concerned, absent special provisions or arrangements. Whether the parties themselves adopt a contract which provides a first option in the corporation and then in other shareholders should not bear on transferability if one applies the concept in a technical rather than practical fashion. At least a modified form of transferability is present. In an example, the Kintner Regulations once recognized transferability in what is called a modified form.⁴¹¹ The example has now been deleted, however, by

410. Bittker, *supra* note 370, at 17.

411. Treas. Reg. § 301.7701-2(g) Example (1) (1960), T.D. 6503, 1960-2 CUM. BULL. 418, provided:

Example (1). A group of seven doctors forms a clinic for the purpose of furnishing, for profit, medical and surgical services to the public. They each transfer assets to the clinic, and their agreement provides that except upon complete liquidation of the organization on the vote of three-fourths of its members, no member has any individual interest in its assets. Their agreement also provides that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion of a member shall cause the dissolution of the organization. Under the applicable local law, on the occurrence of such an event, no member has the power to dissolve the organization. The management of the clinic is vested exclusively in an executive committee of four members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Members of the clinic are personally liable for all debts of, or claims against, the clinic. Every member has the right to transfer his interest to a doctor who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While it does not have the corporate characteristic of limited liability, it does have the characteristics of centralized management, continuity of life, and a modified form of free transferability of interests. The organization

the amendments to the regulations⁴¹² discussed below. Since the shares of professional corporations and associations are transferable without consent of all members, even if subject to a first option arrangement, transferability is present in the sense that that concept has been applied. If a factual test is applied, on the other hand, few closely held corporations have transferability.

The Kintner Regulations made some changes in the wording of the partnerships and trusts classification sections. In each case the basic change is to remove references to specific criteria (limited liability) in these sections and to refer to the general tests stated for classification of organizations for tax purposes. The partnership section is expanded somewhat to illustrate situations which are not partnerships, generally forms of joint ownership of property without carrying on a business.⁴¹³ The limited partnership section⁴¹⁴ and the partnership association

will be classified as an association for all the purposes of the Internal Revenue Code.

412. Treas. Reg. § 301.7701-2(g) (1965), T.D. 6797, 1965 INT. REV. BULL. No. 9, at 40.

413.

§ 301.7701-3 PARTNERSHIPS.—(a) *In general*.—The term “partnership” is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. Thus, the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954. A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

Treas. Reg. § 301.7701-3(a) (1960).

414. Treas. Reg. § 301.7701-3(b) (1960):

(b) *Limited partnership*.—(1) *In general*.—An organization which qualifies as a limited partnership under State law may be classified for purposes of the Internal Revenue Code as an ordinary partnership or as an association. Such a limited partnership will be treated as an association if, applying the principles set forth in § 301.7701-2, the organization more nearly resembles a corporation than an ordinary partnership or other business entity.

Two examples on limited partnerships follow this provision.

section⁴¹⁵ merely state a test of resemblance to a corporation. The trust provisions⁴¹⁶ were rewritten to omit the specific tests and to

415. Treas. Reg. § 301.7701-3(c) (1960):

(c) *Partnership associations*.—The laws of a number of States provide for the formation of organizations commonly known as partnership associations. Such a partnership association will be treated as an association if, applying the principles set forth in § 301.7701-2, the organization more nearly resembles a corporation than the other types of business entities.

416. Treas. Reg. § 301.7701-4 (1960):

TRUSTS.—(a) *Ordinary trusts*.—In general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

(b) *Business trusts*.—There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. However, the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if, applying the principles set forth in §§ 301.7701-2 and 301.7701-3, the organization more nearly resembles an association or a partnership than a trust.

(c) *Certain investment trusts*.—An “investment” trust of the type commonly known as a management trust is an association, and a trust of the type commonly known as a fixed investment trust is an association if there is power under the trust agreement to vary the investment of the certificate holders. See *Commissioner v. North American Bond*

describe various forms of trust, ordinary trusts, business trusts, certain investment trusts, and liquidating trusts.

5. *The "Calculus" of the Kintner Regulations*

While recognizing the factors of associates, an objective to carry on business and divide the gains therefrom, continuity of life, centralization of management, limited liability, and free transferability of interests, the regulations do not recognize explicitly such factors as centralization of title⁴¹⁷ and ability to sue and be sued in the corporate name.⁴¹⁸ These factors seem at least as important as all the factors mentioned in the regulations except limited liability. Furthermore, in deciding whether an organization is an association or a partnership, the Kintner Regulations do not consider the factors of either associates or an objective to carry on business and divide gains, since they are common to both associations and partnerships.⁴¹⁹

Trust (C.C.A.2d 1941) 122 F.2d 545, cert. denied, 314 U.S. 701. However, if there is no power under the trust agreement to vary the investment of the certificate holders, such fixed investment trust shall be classified as a trust.

(d) *Liquidating trusts*.—Certain organizations which are commonly known as liquidating trusts are treated as trusts for purposes of the Internal Revenue Code. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Internal Revenue Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust. Bondholders' protective committees, voting trusts, and other agencies formed to protect the interests of security holders during insolvency, bankruptcy, or corporate reorganization proceedings are analogous to liquidating trusts but if subsequently utilized to further the control or profitable operation of a going business on a permanent continuing basis, they will lose their classification as trusts for purposes of the Internal Revenue Code.

417. See text accompanying notes 87-88 *supra*.

418. See note 273 *supra* and accompanying text.

419. Treas. Reg. § 301.7701-2(a)(2) (1960):

(2) Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential character-

A key section provides the rules for weighing the various criteria deemed relevant under the regulations:

(3) *An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics.* In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association. Although the limited partnership also has associates and an objective to carry on business and divide the gains therefrom, these characteristics are not considered because they are common to both corporations and partnerships.⁴²⁰

This section introduces the novel test of whether the organization has more corporate characteristics than noncorporate characteristics. Previously, the inquiry was whether the organization resembled a corporation.⁴²¹ Furthermore, the weighing is done in a very mechanical manner; each criterion has the same weight, and apparently one has to show three out of four characteristics to find corporate existence.

Here the Kintner Regulations are the most objectionable. First, factors just as relevant as some of the rather thin criteria specified

istics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association. Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association, depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

420. Treas. Reg. § 301.7701-2(a)(3) (1960). (Emphasis added.)

421. See text accompanying note 119 *supra*.

are omitted; second, all criteria are weighted equally; third, it takes three out of four to find corporate classification. Why two out of four noncorporate characteristics requires classification as a partnership, rather than as an association, is not explained. Nowhere is justification given for applying each criterion as though it had weight equal to the others. The approach of this section of the Kintner Regulations is not supported by either the cases or the early regulations. The cases and Professor Sneed's article make it clear that some factors are more important than others. Since some factors seemingly *are* more important than others, this section of the regulations should be discarded, even if all the details on each criterion are accepted.

6. *Summary of Application of the Kintner Regulations to the Model Cases*

For the reasons explained above the Kintner Regulations appear to be unsupported in many details by the early regulations and the cases. They represent a great change in the regulations, quite a step from both the earlier regulations and the cases, which had a strong sweep toward association classification. Consequently, they represent an attempted change in the law through regulations which should not be accepted without justification. But even if the Kintner criteria are adopted, the professional corporation and association should and would be classified as associations under the provisions, if reasonably applied. These regulations are almost entirely keyed to local law, and these professional corporation and association acts do provide the required characteristics under a technical, local law approach.

E. THE AMENDMENTS TO THE KINTNER REGULATIONS

The Kintner Regulations put great emphasis on local law. Apparently the local law application of any criterion would not be altered greatly by any agreement between the owners, at least not one to create corporateness; but some indication is given that a somewhat diluted form of corporateness would result from a buy-out agreement. Nothing indicates that an agreement could increase the corporateness of, for instance, a partnership. All these matters are left to implication, however, and the general impression one gets is that local law is applied without much attention to anything else. As a result, the professional groups took the Kintner Regulations as an invitation to change local law and therefore sought legislation which would provide the

local law to give their professional groups the characteristics of a corporation when adopting the form of a professional association or professional corporation.

The amendments to the Kintner Regulations, discussed in this section, provide the reaction of the Internal Revenue Service. Amendments to the Kintner Regulations were proposed⁴²² and, after more than a year, were adopted on February 2, 1965.⁴²³ The early cases and regulations, on the whole, tended to sweep organizations into the association category by reference to corporate characteristics found in local law, or in the agreements themselves. The Kintner Regulations moved somewhat in the other direction by heavily emphasizing local law and the use of a three-out-of-four approach in weighing criteria for corporateness. The amended regulations represent a strong further sweep toward classification of certain groups as partnerships. The primary method is to refer to anything in local law, agreements, legal relationships of the members among themselves and with the public, and ethics of a professional group, which, however slightly, differs from a typical business corporation, and then to magnify that slight difference into a rule compelling classification as a partnership.

The amendments to the Kintner Regulations attempt to dispose of the relevance of labels in the classification problem:

Nevertheless, the labels applied by local law to organizations, which may now or hereafter be authorized by local law, are in and of themselves of no importance in the classification of such organizations for the purposes of taxation under the Internal Revenue Code. Thus, a professional service organization, formed under the law of a State authorizing the formation by one or more persons of a so-called professional service corporation, would not be classified for purposes of taxation as a "corporation" merely because the organization was so labeled under local law. See *Morrissey et al. v. Commissioner* . . . , 296 U.S. 344 (1935). The classification in which a professional service organization belongs is determined under the tests and standards set forth in §§ 301.7701-2, 301.7701-3, and 301.7701-4.⁴²⁴

To relegate local law labels to nothingness in the classification of organizations may be an overstatement. The classification is made, whatever set of criteria are applied, on rather technical grounds. It is doubtful that the label itself is less relevant and weighty than some of the criteria applied. Furthermore, that the label "corporation" has no relevance, as the proposed regulation asserts, is quite doubtful. First, the statutory language refers to

422. 28 Fed. Reg. 13750 (1963) (§§ 301.7701-1(d), 7701-2(g), (h)).

423. 30 Fed. Reg. 1116 (1965).

424. Treas. Reg. § 301.7701-1(c) (1965).

corporations in a way that makes one think Congress merely intended to have us look to whether a state had issued a charter labeled "corporation" to the organization.⁴²⁵ Second, the legislative history reinforces the view that businesses having a corporate charter were to be classified as corporations, and that the classification problem related to businesses without corporate charters.⁴²⁶ Third, the cases provide no clue that the corporate label is irrelevant — no cases hold that a "corporation" is a partnership, for instance.⁴²⁷ All these arguments, of course, assume that no attempt has been made to create a sham organization or a sham statute, such as a mere relabeling of the Uniform Partnership Act as the "Business Corporation Act." Fourth, in view of the technical approach of the regulations, the local law label may be just as good an indication as the other criteria, particularly where the organization has the label "corporation." Fifth, the Kintner Regulations, before amendment, did not purport to have anything to do with the classification of corporations which, absent such regulations, would not be in doubt; they apparently were wholly concerned with what is an association, an association taxable as a corporation. This provision is intended to pass all those points and to make the label of no weight in the classification.

1. *Continuity of Life*

The amendment to the Kintner Regulations relating to continuity of life of professional service organizations is as follows:

(2) A professional service organization does not have continuity of life within the meaning of paragraph (b) of this section if the death, insanity, bankruptcy, retirement, resignation, expulsion, professional disqualification, or election to inconsistent public office of any member will [in fact] (determined without regard to any agreement among the members) cause *under local law* the dissolution of the organization. A business corporation has a continuing identity *as an entity* which is not dependent upon a shareholder's active participation in any capacity in the production of the income of the corporation. Furthermore, the interest of a shareholder in an ordinary business corporation includes a right to share in the profits of the corporation, and such right is not legally dependent (determined without regard to any agreement among the shareholders) upon his participation in the production of the corporation's income. However, the interest of a member of a professional service organization generally is inextricably bound to the establishment and continuance of an employment relationship with the organization, and he cannot share in the profits of a professional service organization unless he also shares in the performance of the services rendered

425. See note 46 *supra*.

426. See text at 611-25 *supra*.

427. See text accompanying note 79 *supra*.

by the organization. For purposes of this paragraph, the term "employment relationship" is used to describe such active participation by the member and is not restricted to the common-law meaning of such term. If local law, applicable regulations, or professional ethics do not permit a member of a professional service organization to share in its profits unless an employment relationship exists between him and the organization, and if in such case, he or his estate is required to dispose of his interest in the organization if the employment relationship terminates, the continuing existence of the organization depends upon the willingness of its remaining members, if any, either to agree, by prior arrangement or at the time of such termination, to acquire his interest or to employ his proposed successor. The continued existence of such a professional service organization is similar to that of a partnership formed under the Uniform Partnership Act, whose business continues pursuant to an agreement providing that the business will be continued by the remaining members after the withdrawal or death of a partner (see paragraph (b) of this section), and is essentially different from the continuity of life possessed by an ordinary business corporation. Consequently, such a professional service organization lacks continuity of life.⁴²⁸

[The material in italics was added to the regulations as proposed; the material in brackets appeared in the proposed regulation, but was omitted in the regulation as adopted.]

This section makes up in length what it lacks in logic and in consistency with precedent. The reliance in the section as proposed upon what will *in fact* occur with respect to continuity is an entirely new concept in the regulations. The early regulations,⁴²⁹ the Kintner Regulations,⁴³⁰ and the cases⁴³¹ do not rely upon or even consider what happens to the continuity of the business "in fact," but rather look to the continuity of the entity as a more or sometimes less technical concept. Whether looking at strict entity continuity, or to the Kintner Regulations, or at provisions by the organization to carry on the business as did the *Kintner* court, the authorities did not consider what might have happened "in fact," if some of the principals died, etc. This "in fact" test requires a prediction concerning what would happen if one of the specified events occurs. Obviously, the entity will not end or be dissolved on any of the specified events, for the statute provides it will continue.⁴³² The proposed regulation, therefore, must refer to the remote possibility of dissolution if one of the specified events occurs, and if the organization does nothing to correct the situation. Since the whole thrust of other

428. Treas. Reg. § 301.7701-2(h)(2) (1965).

429. See text accompanying note 300 *supra*.

430. See text accompanying notes 357-61 *supra*.

431. See text accompanying notes 202-06 *supra*.

432. GA. CODE ANN. § 84-4309 (Supp. 1963).

authorities is against considering what happens "in fact," this sentence was completely out of line with the cases and earlier regulations. Furthermore, there is no apparent reason for changing the test. Presumably, if changed for one sort of corporation, it would be changed for all; there is no obvious reason why such a factual approach would be used for professional groups, and not for other businesses. The omission of "in fact" from the final regulation and the addition of "under local law" may cure the defect described if the language does not mean "might possibly cause . . . the dissolution"

The next sentence states, "A business corporation has a continuing identity as an entity which is not dependent upon a shareholder's active participation in any capacity in the production of the income of the corporation."⁴³³ This statement may describe correctly how people look at large corporations, and, of course, is also true of any corporation in the technical entity meaning of continuing identity. But the assertion is not true, in the factual sense, of a closely held corporation, whose continuance depends greatly upon both the type of business and the individuals concerned; such a corporation may, or may not have such "continuing identity." The second sentence is obviously inconsistent with the approach taken in the cases and the early regulations, if it refers to continuing identity in the factual sense; because, so applied, almost any closely held corporation would lack continuity, whether the business renders personal services or not. But the second sentence probably refers to the entity concept, especially since the words "as an entity" were added to the language as originally prepared.

The third sentence — "Furthermore, the interest of a shareholder in an ordinary business corporation includes a right to share in the profits of the corporation, and such right is not legally dependent (determined without regard to any agreement among the shareholders) upon his participation in the production of the corporation's income"⁴³⁴ — seems true on its face, although the relevance to the classification question is not apparent. Some limitations must be observed, however. No shareholder, as a shareholder, has a right to a dividend or, except in unusual cases, to compel the declaration of a dividend or to compel liquidation.⁴³⁵ Also, stock in personal service corporations rarely has any substantial value. Therefore, while the statement seems true in a limited sense, if it intends to suggest that what the professional re-

433. Treas. Reg. § 301.7701-2(h)(2) (1965).

434. *Ibid.*

435. 2 O'NEAL, CLOSE CORPORATIONS § 8.08, at 111 (1958).

ceives as a shareholder depends legally, or technically, upon what his contribution was in services, then the statement is objectionable as inconsistent with the concept of a shareholder. If it refers to the practical connection between income of the professional and what he gets out of the corporation in any form, the statement is then objectionable as inconsistent with the technical, entity concept of continuity adopted in the Kintner Regulations and even in these amendments.

The fourth sentence seeks to distinguish the professional corporation from the "ordinary business corporation" by saying, "However, the interest of a member of a professional service organization generally is inextricably bound to the establishment and continuance of an employment relationship with the organization, and he cannot share in the profits of a professional service organization unless he also shares in the performance of the services rendered by the organization."⁴³⁶ Obviously, the practical connection between the shareholder of a closely held corporation and his active participation in the business as an employee is very close, but that relationship does not really make the professional service corporation different. Furthermore, the relevance of this observation in the amended regulation is obscure. How is the classification for tax purposes affected, especially where no practical difference exists between the closely held corporation and the professional service corporation? Note also that literally part of the fourth sentence is a false statement; *i.e.*, "he cannot share" In fact the professional service corporation member *can* share in the profits of the organization whether he actively participates or not; indeed, it is not unusual for a member of a professional group to share in the profits when he is disabled or retired. The general point made in the fourth sentence has no relevance, therefore, and is inconsistent with the test prescribed for other types of organizations in section 301.7701-2(b).

Next, the regulations talk about continuing existence depending upon willingness of the remaining members to acquire the interest of a member, or his estate, when the member is required by "local law, applicable regulation, or professional ethics" to dispose of the interest in the organization.⁴³⁷ Of course, this view is quite inconsistent with the entity concept of the Kintner Regulations; in no sense does the entity terminate just because a member becomes disqualified, dies, etc. Transferability of interest, if anything, is involved here. The continuity of the entity cannot be said to be affected just because of some remote chance

436. Treas. Reg. § 301.7701-2(h)(2) (1965).

437. *Ibid.*

of dissolution after judicial proceeding if an association does not acquire the interest of the dead or disqualified member. The possibility is remote, and in fact the disqualification or death itself has no immediate impact on the continuity of the organization. Therefore, neither the earlier regulations nor reason justifies this portion of the amended regulation.

The next sentence of this section is remarkable:

The continued existence of a professional service organization is similar to that of a partnership formed under the Uniform Partnership Act, whose business continues pursuant to an agreement providing that the business will be continued by the remaining members after the withdrawal or death of a partner (see paragraph (b) of this section), and is essentially different from the continuity of life pursued by an ordinary business corporation.⁴³⁸

No statement is made of how the existence of the professional service organization is similar to that of a partnership. Since the partnership does dissolve upon the death, etc., of a member, and since the professional service corporation does not, more than a bare assertion is needed to demonstrate similarity. Likewise, the "essentially different" nature of the continuity of life is elusive, to say the least. This sentence is contrary to the Kintner Regulations, the cases, and early regulations. No justification is provided.

Since partnerships do have continuity of life in one sense, the Kintner Regulations emphasized local law, which provides for technical dissolution of the partnership as the means for the finding that partnerships do not have the continuity of a corporation.⁴³⁹ However, the Minnesota professional service corporation statute provides continuity with no technical dissolution. No dissolution is specified, but the certificate of registration may be revoked upon the occurrence of an extraordinary event, after public hearing and an opportunity for judicial appeal.⁴⁴⁰ Literally, the professional associations may have continuity even under the amended provision, since the facts asserted — concerning participation in profits — are not generally true. However, the whole section is intended to deprive these groups of continuity, and, therefore, it might be concluded they do not have continuity if this section is valid.

2. *Centralized Management*

Concerning the centralized management criterion, the amended regulations provide:

438. *Ibid.*

439. See text accompanying notes 357–59 *supra*.

440. MINN. STAT. §§ 319.12–14 (1961).

(3) In applying the rules of paragraph (c) of this section, relating to centralization of management, a professional service organization does not have centralization of management where the managers of a professional service organization *under local law are not vested with* [lack] the continuing exclusive authority to determine any one or more of the following matters: (i) the hiring and firing of professional members of the organization and its professional and lay employees, (ii) the compensation of the members and of such employees, (iii) the conditions of employment—such as working hours, vacation periods, and sick leave, (iv) the persons who will be accepted as clients or patients, (v) who will handle each individual case or matter, (vi) the professional policies and procedures to be followed in handling each individual case, (vii) the fees to be charged by the organization, (viii) the nature of the records to be kept, their use, and their disposition, and (ix) the times and amounts of distributions of the earnings of the organization to its members as such. Moreover, although a measure of central control may exist in a professional service organization, the managers of a professional service organization in which a member retains traditional professional responsibility cannot have the continuing exclusive authority to determine all of the matters described in the preceding sentence. Instead, such measure of central control is no more than that existing in an ordinary large professional partnership which has one or more so-called managing partners and in which a member retains the traditional professional autonomy with respect to professional decisions and the traditional responsibility of a professional person to the client or patient. Such measure of central control is essentially different from the centralization of management existing in an ordinary business corporation. Therefore, centralization of management does not exist in such a professional service organization.⁴⁴¹

[Material in brackets appeared in the amendment as proposed, but was omitted in the final regulations; the words in italics were added to the original proposal.] This provision, in all its detail, is considerably different from the concept as developed in the cases and the early regulations. It is even quite different from the concept of centralized management in the original Kintner Regulations.

In one sense both partnerships and corporations can achieve a factual sort of centralization of management, depending upon the personal relationships of the people involved. In a partnership one partner may be, for all practical purposes, an assistant or an employee of another partner, in the sense that his work is closely directed. Of course, the same thing may happen in a corporation. Moreover, the opposite can be true—the corporate employee may be subject to no particular supervision on any matter of importance. Therefore, if centralized management is sought as a criterion for distinguishing partnerships and corporations, a technical, conceptual approach is necessary rather than

441. Treas. Reg. § 301.7701-2(h)(3) (1965).

a factual description of the relationship of the parties. In the technical sense, both professional partnerships and professional corporations may have professional employees, obviously, and control these employees to some extent. Such an employee may be given considerable freedom in his professional decisions, or he may be closely supervised. No particular difference distinguishes the partnership and the corporate form in this respect, whether or not the organization is a professional group. Technically, the relationship of the members of a partnership differs somewhat from that of the shareholders of a corporation. The partners have certain rights as more or less equals, while local law imposes a hierarchy upon a corporation — shareholders, board of directors, and officers. Of course, either the partnership or the corporation can modify, by agreement, the structure it would otherwise have under local law, but the technical difference is present. Presumably, professional corporations and associations have the same technical structure as other corporations.

The amended regulation, however, starts with an enumeration of functions which must be centralized in fact. Note that if any *one* function on the list is not centralized, there is not centralization. This extreme position, this contrived test, is an absurdity. Nowhere has centralization been defined in such strict, narrow terms and the all-or-nothing approach is not justified.

The regulation also places emphasis on centralization of "the professional policies and procedures to be followed in handling each individual case," further saying that "the managers of a professional service organization in which a member retains traditional professional responsibility cannot have" centralization.⁴⁴² Of course, there is no reason in law why there could not be control over the professional decisions of the professional employee. Normally, no control is exercised, just as any highly trained employee seldom is closely supervised, particularly in a personal service business. That proposition hardly needs support. And if such control does not exist, in fact, for one reason (such as desirable delegation of authority) or another (such as "professional ethics"), it is difficult to understand how centralization, as that term seems to be used as a technical term, is diluted. The professional independence that is referred to has most of its vitality only in the independence from lay control; nothing in law prevents one professional from employing and controlling another.

Furthermore, even if it were relevant to examine the extent of centralization in fact, the professional corporation probably

442. *Ibid.*

has the required centralization of control over important matters such as salaries, employment of professional personnel, disposition of conflicts of interest, or assignments of work. The whole point of setting up clinics — and these existed long before the present controversy — is to obtain efficiency through specialization; this goal could not be reached without centralization of management in a significant amount. In examining the importance of the relationship of the professional to the client, no particular difference can be found in whether the professional is an employee of a partnership or a partner. Furthermore, one can find examples of the practice of medicine by hospitals, clinics, and group health organizations, many of which are clearly corporations. The relationship to the client is the same.

The Internal Revenue Service *has* recognized sufficient centralization in a medical group in a ruling issued to the Colony Medical Group.⁴⁴³ The regulation's statement that "such measure of central control is essentially different from the centralization of management existing in an ordinary business corporation"⁴⁴⁴ is most doubtful, and the more logical comparison would seem to be with a closely held corporation, perhaps in a personal service business. Note also that, in fact, a great deal of decentralization exists in corporations, particularly in determinations by personal service corporations as to how the personal service shall be rendered. The "essentially different" statement is another example of several unfounded and unsupported assertions of fact in these amended regulations.

In conclusion, this section of the proposed regulations is completely out of tune with the cases and preceding regulations. It is a rather obvious attempt to exalt any tiny factual difference into a universal principle on the classification question. Under the amended regulations, professional corporations and associations apparently do not have centralized management.

3. *Limited Liability*

The amendments treat limited liability as follows:

- (4) A professional service organization has the corporate characteristic of limited liability within the meaning of paragraph (d) of this section only if the personal liability of its members, *in their capacity as members of the organization*, is no greater in any aspect than that of shareholder-employees of an ordinary business corporation. If under

⁴⁴³ Special Ruling, March 2, 1961 (Colony Medical Group), 2 CCH PENSION PLAN GUIDE (2d ed.) ¶ 12927 (1962).

⁴⁴⁴ Treas. Reg. § 301.7701-2(h)(3) (1965).

local law and the rules pertaining to professional practice, *a mutual agency relationship, similar to that existing in an ordinary professional partnership, exists between the members of a professional service organization*, [the liability of a professional person to the clients or patients of the professional service organization is more extensive than the personal liability of a shareholder-employee of an ordinary business corporation to its customers or patrons, the professional service] such organization lacks the corporate characteristic of limited liability.⁴⁴⁵

[Material in brackets appeared in the amendment as proposed, but was omitted in the final regulations; the words in italics were added to the original proposal.]

Justification was, of course, impossible for the proposition that any difference in liability, however slight, between the liability of the shareholder-employee of a business corporation and the professional shareholder-employee of a professional corporation required the conclusion that the latter has no limited liability. Such a strange notion has no foundation anywhere. At the least, it is obvious that if there is a substantial difference in the liability of the professional employee-shareholder of a professional corporation and of the partner, the former has limited liability. The arguments have been discussed above concerning whether the liability of an employee of a professional corporation differs much, if any, from the employees of other corporations. The liability, or limitation thereof, was concluded to be the same.⁴⁴⁶

Furthermore, the *proposed* regulation confused the limited liability of *shareholders* with the personal liability of *employees*. The employee of any corporation is liable for his own negligence. The corporation is liable also under the doctrine of respondeat superior. The professional employee may have a personal liability more extensive than the ordinary employee of a corporation, but only as a professional, not as an employee.⁴⁴⁷ This greater liability — perhaps for the negligence of an assistant, perhaps for a promise to cure — arises out of his professional duties, not out of his capacity as a corporate or noncorporate employee. The words added in the final form of the amendment apparently cure this defect. Consequently, there will be limited liability unless there is the liability of a partner.

The Colorado professional corporation should have a strong case for limited liability, even under the amended regulation. Likewise the Minnesota professional corporation has a strong case. One remedy to the problem raised by the proposed amend-

445. Treas. Reg. § 301.7701-2(h)(4) (1965).

446. See text accompanying note 400 *supra*.

447. See text accompanying notes 400-02 *supra*.

ment might be state legislation to make it clear that the personal liability of shareholder-employees of professional corporations is no greater in any respect than that of shareholder-employees of an "ordinary business corporation."

4. *Transferability of Interest*

The last criterion discussed in the amendments to the Kintner Regulations is transferability of interest. The amendment as adopted states:

If the right of a member of a professional service organization to share in its profits is dependent upon the existence of an employment relationship between him and the organization, free transferability of interests within the meaning of paragraph (e) of this section exists only if the member, without the consent of other members, may transfer both the right to share in the profits of the organization and the right to an employment relationship with the organization.⁴⁴⁸

This section may say that where membership is not necessarily, as a matter of local law, dependent upon the existence of an employment relationship, there can be transferability of interest. So far as the enabling law requires, the stockholder of a professional corporation or association need be only a member of the same profession; he need not be an employee.⁴⁴⁹ A disabled or retired employee might well be allowed to retain his stock. An estate of a shareholder is even allowed to retain stock for some time.⁴⁵⁰ Consequently, these groups do not seem to be disqualified for transferability by this section.

On the other hand, if the section means a relationship between ownership and employment exists as a practical matter, then the distinction between professional and other corporations seems contrived. When one compares the closely held corporation and

448. Treas. Reg. § 301.7701-2(h)(5)(i) (1965). The proposed amendment stated:

The right of a member of a professional service organization to share in its profits is generally dependent upon the existence of an employment relationship between him and the organization. In such case, free transferability of interests within the meaning of paragraph (e) of this section exists only if the member, without the consent of other members, may transfer both the right to share in the profits of the organization and the right to an employment relationship with the organization.

28 Fed. Reg. 13752 (1963). The only difference seems to be that the amendment as adopted avoids the factual assertion in the proposed version.

449. GA. CODE ANN. § 84-4310 (Supp. 1963); MINN. STAT. ANN. § 319.18 (Supp. 1964).

450. GA. CODE ANN. § 84-4310 (Supp. 1963); MINN. STAT. ANN. § 319.19 (Supp. 1964).

the professional service corporation, no relevant differences appear on this count. The closely held corporation, especially in a personal service business, is likely to have identity of shareholders with principal employees, as a matter of fact.

An interesting point is that if the shareholder-employee had the right to transfer both the right to share in profits and an employment relationship, there would be diminution of centralization of management under the amended regulations. With such principles, it is hard to win.

The amendment to the regulations next discusses the commonly found right of first refusal, when found in a professional corporation:

The corporate characteristic of free transferability of interests exists in a modified form within the meaning of paragraph (e)(2) of this section when a shareholder in an ordinary business corporation can transfer his interest in such corporation only after having offered such interest to the other shareholders at its fair market value. In such a case, the so-called right of first refusal applies only to an interest which is a right to share in the profits, the assets, and the management of the enterprise. However, if the interest of a member of a professional service organization constitutes a right to share in the profits of the organization which is contingent upon and inseparable from the member's continuing employment relationship with the organization, and the transfer of such interest is subject to a right of first refusal, such interest is subject to a power in the other members of the organization to determine not only the individuals whom the organization is to employ, but also who may share with them in the profits of the organization. The possession by other members of the power to determine, in connection with the transfer of such an interest, whom the organization is to employ is so substantial a hindrance upon the free transferability of interests in the organization that such power precludes the existence of a modified form of free transferability of interests. Therefore, if a member of a professional service organization who possesses such an interest may transfer his interest to a qualified person who is not a member of the organization only after having first offered his interest to the other members of the organization at its fair market value, the corporate characteristic of free transferability of interests does not exist.⁴⁵¹

451. Treas. Reg. § 301.7701-2(h)(5)(ii) (1965). The proposed amendment read:

(ii) Although a so-called right of first refusal in connection with the transfer of the interest of a shareholder of an ordinary business corporation may not prevent a modified form of transferability of interests within the meaning of paragraph (e) of this section, such right of first refusal applies only to the right to share in the profits and assets of the enterprise. The interest of a member of a professional service organization, however, constitutes a right to share in the profits of the organization which, in addition, generally is contingent upon and inseparable from the member's continuing employment relation-

The amendment as adopted does talk in terms of condition (if), rather than asserting what generally is the case, as did the proposed regulation. This language may provide some ray of hope if the word inseparable means inseparable under local law, and not inseparable under the agreement between the parties, or even inseparable in fact, or as a practical matter.

The right of first refusal is difficult to see as a great hindrance to transferability. The right of first refusal may be regarded either as a veto power or as the normal way to dispose of stock by having the corporation acquire it. If merely a veto power, then normally it would not be exercised, and consequently the stock would be transferable. If the corporation normally acquires the shares when offered, or on certain occasions, then the liquidity of the investment in those shares is preserved, and the interests of transferability are thereby well served.

The first option provision is extremely common in smaller corporations — indeed almost the rule, and therefore, normal corporate practice. The courts, indeed, have gone so far as to give effect to a bylaw which vested the stock of a director or employee immediately in the directors or trustees when the director or employee left the firm.⁴⁵²

If the amendment is aimed at organizations which are subject to a local law tying the employment relation to stockholding by requiring that all stock be owned by active employees, then such groups will not have transferability if the amendment is valid. On the other hand, other groups with no such local law restriction, as for instance the professional corporation and professional associations herein discussed, will have transferability. If, however, the amended regulation is aimed at groups which do, by agreement, limit stock ownership to active employees only, then

ship with the organization. If the transfer of such an interest is subject to a right of first refusal, the other members of the organization have the power to determine not only the individuals who may share in the profits of the organization, but also the individuals whom the organization is to employ. The possession by other members of such power to determine whom the organization is to employ in connection with such a transfer is incompatible with the free transferability of a member's interest. Therefore, if a member of a professional service organization may transfer his interest to a qualified person who is not a member of the organization only after having first offered his interest to the other members of the organization, the corporate characteristic of free transferability of interests does not exist.

28 Fed. Reg. 13752 (1963). No great change is apparent from proposed to final amendment.

452. *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951).

the scope of the regulation is quite broad and would cause difficulty for many professional corporations and associations. At the extreme, if the amended regulation purports to refer to whether employment is — as a practical matter, if not by agreement — tied to stock ownership and vice versa, then many more professional corporations and associations will be affected, if the regulations are valid. The transfer of shares and the employment relationship are legally separate. On the other hand, the practical relationship between ownership and employment obviously exists for many closely held corporations. The corporation has the power to determine who will be its employees whether or not by means of a right of first refusal. Consequently, the only reasonable interpretation of the amended regulation is that it is aimed at the first case stated, a situation in which local law requires stock to be held only by active employees.

However, the amended regulation is not consistent with earlier regulations and the cases which draw no such distinction. The dispositive point perhaps should be that under local law the stock of a professional corporation would be *more* transferable than a partnership interest in a similar organization. There would be fewer local law complications, such as technical dissolution, right to an accounting, different right of creditors and different liability of partners, and probably different vote required. Thus, even an organization which is required to have stock held by only active employees has more transferability than a partnership. Depending upon how the amended regulation is interpreted, professional corporations and associations may have transferability, or a modified form of transferability, under the regulations.

SUMMARY AND CONCLUSION

The various versions of the statute and legislative history suggest Congress probably intended, in the beginning, to classify business organizations according to local law for federal income tax consequences. This classification was apparently to be made by local law label, so long as the label was not a sham. It was recognized that the difference in form of organization under local law could result in different consequences to businesses similar in all respects except for the formal structure under local law. It was recognized that personal service corporations were so like partnerships that, for a brief period, they were treated as partnerships for tax purposes; but it was decided to revert to taxing personal service corporations as corporations, according to the local law classification.

The courts, largely following the regulations, tended to classify borderline groups as associations. The courts looked to the agreement governing the relationship of the parties in finding characteristics which supported classification of these groups as associations. In all the medical cases litigated, the groups have been classified as associations. Clearly the professional corporation and professional association would be classified under these cases as corporation and association for federal income tax purposes.

For 50 years the regulations consistently tended to classify borderline cases as associations. At one point Congress reversed this tendency for certain groups strongly resembling partnerships. The regulations spoke of various factors as indicators of corporateness, and seemed to emphasize local law in discussing these indicators, although without explicitly rejecting the agreement of the parties as relevant. Under this long line of regulations, classification of professional associations and corporations would clearly be as corporations. This long-standing regulatory approach to the classification question was abruptly changed in the wake of the *Kintner* case by the publication of the Kintner Regulations which seemed to place ultimate reliance on the significance of local law in applying each criterion of corporateness, and which reject the use of the agreement between the parties as a source of corporate characteristics, although not as a source of diluting corporate characteristics. Nevertheless, classification of professional associations and corporations would probably be as associations and corporations, rather than as partnerships, under these regulations, because these groups seem to have the required characteristics for corporateness. Finally, in the recent amendments to the Kintner Regulations, the Internal Revenue Service has pushed to an extreme and suggests that professional associations and corporations are partnerships, rather than associations and corporations, for federal tax purposes. Thus, the system is changed from the pre-Kintner regulations sweeping all doubtful cases into the association category, to a more neutral position in the Kintner Regulations based on heavy reliance on local law, and finally to the amended Kintner Regulations sweeping all "doubtful" cases (or at least professional associations and corporations) into the partnership category. These amendments grasp for any distinction between what they refer to as typical business corporations and professional groups. Then the thin distinction is magnified into a universal indication of the absence of corporateness. These amended regulations appear to use local law, professional ethics, and the agreement governing the relationship of the parties, wherever possible, to *deny* classification as association or corpora-

tion; but, on the other hand, they *ignore* the agreements between the parties when they attempt to impute a corporate characteristic to the organization in its natural form under local law. When practicalities detract from corporateness, they are emphasized; when they tend to support the presence of a corporate characteristic, they are ignored.

Under these amendments, professional associations and corporations would probably be classified as partnerships. The Kintner Regulations and the amendments require *better than* two out of four of the corporate characteristics for classification as an association or corporation; the presence of only two out of four requires classification as a partnership.

The Kintner Regulations in some respects are inconsistent with the earlier regulations and with the cases; the amended regulations are almost wholly inconsistent with them. If the principles of the amendments were applied to the entire classification system, not just to professional groups, the result would probably be that no closely held, personal service organization could be a corporation for federal income tax purposes. Since that broad change of approach to the problem probably was not intended, the result appears to be a special set of rules — not entirely consistent with the general rules — for classification of professional groups. Why these groups require special, discriminatory-in-application, rules is not readily apparent.

All these systems of classification seem to apply, rather shallowly, certain differences between corporations and partnerships, without an examination of the relevance of the differences for federal income tax consequences. Where this application is a result of mere adoption of the local law classification, it is understandable as consistent with what was probably the legislative intent; but the relevance of the highly strained and extreme distinctions drawn under the amended Kintner Regulations is less evident. Whereas the cases and the regulations appear to give more weight to, for instance, limited liability, the Kintner and amended Kintner Regulations weigh each "characteristic" the same, and omit certain characteristics which once were used to justify classification of groups as associations.

Of course, nothing in the statutes *compels* a court to take one view or the other on this classification question. With a wide possible range of interpretations of the statutory "definitions" that might be considered by a court, or by one who predicts what a court might do, or by one who suggests what a court *should* do, it is necessary to develop a framework for deciding which classification system should be followed in these cases. The issue is:

How should professional associations and corporations, as described earlier in this article, be classified for federal income tax purposes?

The case for classifying these groups as partnerships depends upon several contentions, but primarily upon the alleged adverse revenue consequences. The revenue question, however, has several aspects. One aspect is the matter of whether less revenue will be collected as a result of classifying these groups as associations rather than as partnerships. The only self evident truth is that the revenue considerations will vary in different circumstances. *Less* revenue will be collected when the recipient of deferred income paid from a pension or profit sharing plan (either the employee or his beneficiary) is in a lower marginal tax bracket; the *same* amount of revenue will be collected when the taxpayer is in the same marginal tax bracket at the time of receipt as the employee was in the year in which the benefit was earned; and *more* revenue will be collected when the recipient is in a higher tax bracket than was the employee when the benefit was earned. It is not readily evident which of these situations prevails overall. Some of the benefits are earned in years when the employee is in a low bracket. By retirement time his income from all sources may be much higher. Even if the income is earned at a time of fairly high personal service income, income from investments may become substantial in later years. Obviously, therefore, there will not be a revenue loss in all cases.

Furthermore, there will be an immediate, if temporary, *increase* in the tax paid by many professional groups changing from the partnership to the corporation form. If the partnership has been operating on a taxable year that is not a calendar year, income from the partnership has been reported for the calendar year during which the partnership year ends, thus causing a deferral of taxation of partnership income. When the group changes to the corporation form, the salaries paid to the doctor employees will be taxable in the year received, not later, and consequently there will be both acceleration and bunching of income, with considerably greater tax paid, and paid sooner, as a result.

At least it is apparent that in the arithmetic of national finance, the alleged adverse effect will not be great. After all the economy withstood a substantial tax cut without suffering. Furthermore, just one revenue ruling, such as the recent ruling on deductibility of treble damage judgments, may have revenue consequences of about the same magnitude.

Another aspect of revenue considerations is the deferral of recognition of income which will clearly result through the typical

pension and profit sharing plan adopted by professional associations and corporations. The impact of this deferral is not likely to be great in any particular year, however, because the transition of these groups to association form, and then the implementation of full pension and profit sharing benefits are likely to consume many years. Also, a large number of professional groups, perhaps more than half, never will change. In any event the income *will* be reported sooner or later.

The relevance of either the assumed revenue loss or the effect of deferral of income to this classification problem is doubtful. They are not supposed to control the deciding of particular tax cases, and they should not be considered when there is as much history — legislative, judicial, and administrative — as in the instant case to provide the basis for decision. To change a long standing rule merely because the revenue considerations have changed does not seem to be a proper use of the power to promulgate interpretative regulations.

Another reason advanced to justify the amended regulations is that doctor and lawyer groups have always been taxed as partnerships and, therefore, Congress intends to continue to tax them as partnerships. Besides the obvious non sequitur, the first difficulty with this argument is that some medical groups have long been operated in the form of associations. The prospect of the application of the amended regulations to those groups serves to put the consistency matter in issue rather clearly and to rebut the factual assertion. The second difficulty is that Congress has evidenced absolutely no intention to restrict these groups to one form or another for federal income tax purposes. The congressional form and intent never included, or froze into the tax law, state-created bars to the practice of professions in the corporate form.

It has been stated that although doctors and lawyers *could* change their forms of organization enough to be classified as corporations or associations, both the professional association discussed herein and some professional corporations have not changed enough. The regulations go far beyond this reasonable, if not persuasive, position. But a position on the classification issue depends on how one reads the authorities, and why. If you start with the Kintner Regulations as gospel, ignore the previous decades of cases and regulations, assume ultimate construction of these enabling statutes in the least helpful way, and then apply the Kintner Regulations in as hostile a manner as possible, you can logically defend the conclusion that these groups are not associations. Whether the doctors and lawyers have arranged for

enough legislative change to enable these groups to achieve association or corporation classification for tax purposes, can also be answered either historically or in terms of the relevant policy considerations. Herein it is argued that history strongly supports the classification of these groups as associations, and that policy reasons require association classification where elected by the group through adopting the association or corporation form under local law. Why the answer should rather be found in a harsh reading of some regulations which are in many respects inconsistent with the cases and the long-standing regulations preceding, is not clear.

Another reason given for denying the corporateness of some organizations is that the state laws have as their sole object the changing of the federal tax treatment of these groups. Presumably, such reasoning also asserts that something is sinister about that objective, and apparently assumes that compelling reasons are present for continuing the traditional classification of these particular groups for tax purposes. The last point is dealt with above. The sinister character of these acts is not apparent. These acts do not affect just federal taxation, but also affect local taxation, and presumably in the same way as the federal revenue is affected. The argument is that the federal courts should not recognize this blatant attempt to change the federal tax consequences to taxpayers by a mere change of state law.

Another way of looking at the matter is that Congress left the matter of form of business to the states, in spite of the resulting differences in taxation of otherwise identical businesses; the statutes enacted are well within the range of that delegation; the states have only acted to remove a traditional bar to doctors and lawyers using the corporate form; these statutes have substantial local law effects, on the same technical level as the admitted differences in corporations and partnerships; and these statutes do have local law tax consequences of the same quality as the federal tax consequences (and if harmful for federal purposes, harmful for state revenue purposes also).

Consequently, it might be argued, the more appropriate role for the federal courts is to recognize these state acts for federal income tax purposes, as Congress no doubt intended, and not to jump to the conclusion that something is sinister and wrong with the removal of a state created bar to practicing law and medicine in the corporate form. If federal tax consequences gave the final push to the state decision to change what were, at most, emotionally based prohibitions, *so what?* Federal tax consequences, and in some cases limited liability, are about the only substantial

considerations in choosing the form for doing business, as a result of decades of lawyer ingenuity in removing the other differences. The states, not surprisingly, are finally recognizing this fact and allowing professional groups, as other businesses, to elect federal tax consequences by their choice of the local law form for doing business.

Presumably, the tax base is not significantly involved in this controversy since the income of the business, with quite minor exceptions, will be taxed eventually. Deferred compensation benefits under an employment contract, pension benefits, and profit sharing benefits all will eventually be included in *someone's* income. Although total exclusion from the tax base is allowed for qualified sick pay and for funds spent on such fringe benefits as group life insurance, these benefits are rather minor and are not important enough in revenue effect to be considered.

There seems to be a lack of discussion of the effect of the incorporation of these groups on the progressive character of our income tax, and the policies served by a progressive tax. Concerning revenue considerations, the discussion set forth above applies. On the level of policies served by progression, it is difficult to see how those revenue considerations are so compelling, if of any merit at all, as to justify different treatment of two groups of "businessmen" in the business of rendering personal services, assuming both groups desire to be classified as associations or corporations. Furthermore, the tax system may be too progressive for personal service income, and yet too riddled with exceptions available to corporate executives and owners, but not to partners.

Finally, the attitude of the Internal Revenue Service might be attributed to a belief that the provisions of the Code on fringe benefits are too liberal, and also have been abused. If so, the remedy is not to deny these benefits to one group of businessmen, while allowing the other groups to retain those benefits. The answer is to attempt reform of the basic provisions applicable to all.

The case for classifying these groups as associations and corporations, as intended by their owners, is simple enough. The classification for tax purposes was intended by Congress to be primarily a local law classification, even if subject to some federal limits. Since the cases and regulations for 50 years tended to classify doubtful groups as associations, that classification system acquired the force of law. The recent attempts to change the law by regulation should not receive favor by the courts. Furthermore, these professional businesses are entitled, so far as federal tax

law is concerned, to choose whatever local law form the states will tolerate. Other businesses may decide whether to adopt the partnership form or the corporation form, and no good reason has been given to deny this choice to those who are in the business of rendering personal services in the medical or legal fields. Stated another way, there is no good reason for treating these businesses differently than other businesses for federal income tax purposes. At stake is the basic element of fairness and equality that should be used in the application and administration of the federal tax laws. The change proposed by the amended Kintner Regulations is one — hazarding a prediction — that Congress would never adopt. Furthermore, for nontax reasons pensions and profit sharing plans are desirable and worthy of some tax benefits. These plans provide incentive for these employer-owners to fund their own retirement through such plans, rather than leave retirement funding to chance. Providing tax incentives to this worthy objective is a legitimate use of the tax laws.

The above analysis calls for a framework to allow these benefits to doctors and lawyers, if they are willing to adopt the appropriate business form, rather than a framework that seems to deny it. In coming to this conclusion no difficulty should be raised by the observation that many will not be able to obtain these benefits — for instance those employed by corporations who have no such plans or those not eligible for coverage under plans adopted. Some day that inequity may be rectified. Therefore, a framework should be adopted consistent with allowing these professional groups to organize under local law as associations and corporations. The framework could be that vague one developed under the cases and pre-Kintner regulations. Classification of these groups as associations and corporations would seem to follow easily.

On the technical level, the reenactment and long-standing rules do give considerable weight to the earlier approach leading to classification of groups as associations. There is no clear authority that the Commissioner can change interpretative rules that have survived many reenactments and that have received "the force of law" by courts adopting the criteria they provide.

But if the Commissioner should be able to change the approach taken in such regulations, the question remains: when, or in other words, for what reasons? Certainly there is merit in consistency in such regulations. Once a position is taken and widely adopted by the courts, it is best to continue the approach, because it is desirable for taxation rules to have good predictability of result,

especially on the basic question of what form a business organization shall have for federal income tax consequences. If change occurs, a period of great turmoil results. Good reasons are needed to support such a change, and minor shifts in revenue advantage are not good enough reasons.

If changes are to be made, the Internal Revenue Service should be respectful of the authorities — legislative history and declarations, and the decided cases of the courts. Sometimes the regulations do have to be changed. The *Clifford* Regulations are an example. But they were bottomed on the *Clifford* case, and served the great need of providing detailed rules for predicting consequences of certain very common arrangements.

The Kintner Regulations, although representing some change of emphasis, do have some utility as a framework for deciding these cases by assuming a reasonable, not a strained and hostile, interpretation of those regulations. The technical, local law approach of those regulations has merit. The criteria of the cases and pre-Kintner regulations were not founded on practicality, and in that respect the Kintner Regulations are no worse. They do provide some ease of application, some predictability. Serious reservations remain concerning the weight of each of the Kintner Regulations criteria. Clearly, in the cases and the pre-Kintner regulations, not all these criteria are of equal importance. Yet the Kintner Regulations make them equal. Clearly, limited liability is of greater importance and has greater weight than the other criteria; perhaps this importance could be reflected by giving that criterion double weight, if a fairly mechanical system must be used. Another advantage to using the Kintner criteria is that they were partly designed to settle the troublesome problem of classification faced by the oil and gas industry. It would not be desirable to unsettle that area by throwing out the Kintner criteria entirely, and it is not necessary to do so since medical and legal groups setting up to do business under the professional corporation and association acts could qualify under the Kintner Regulations, reasonably interpreted, as associations. While approving the Kintner Regulations might seem to be a slight compromise with the history of the pre-Kintner regulations and cases, it can be defended as a useful and fair compromise. More important, it can also be defended as a return to what Congress probably intended originally, to let local law determine the form of business and to let tax classification normally follow. The pre-Kintner regulations and the cases were not necessarily well balanced or justified in their tendency to classify all doubtful cases as associations.

The amendments to the Kintner Regulations, on the other hand, have no support historically, are not a balanced, fair approach to the problem, and discriminate against certain professional groups without justification. Consequently, a court need not follow such changes unless the Commissioner convinces it that compelling reasons of legislative policy justify the change, and that the court is a better forum for the legislative change than the legislature. That should be the burden of the Internal Revenue Service in these cases.

The Kintner Regulations, before amendment, are a good illustration of the proper exercise of the power to change interpretative regulations, if it exists, since they more faithfully interpret the original intent of Congress, since they aid predictability, and since they have the practical value of avoiding excursions into a morass of facts.

